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Commissioner	:	Michael Picker
Administrative Law Judges	:	Rafael Lirag Douglas Long
ORA Witness	:	Mehboob Aslam



**OFFICE OF RATEPAYER ADVOCATES  
CALIFORNIA PUBLIC UTILITIES COMMISSION**

**PUBLIC  
REPORT  
ON LABOR AND PENSION & BENEFITS  
Golden State Water Company  
Test Year 2016 General Rate Case  
A.14-07-006**

**San Francisco, California  
March 6, 2015**

## **MEMORANDUM**

This Report on Labor and Pension & Benefits is prepared by Mehboob Aslam of the *Office of Ratepayer Advocates (ORA) - Water Branch*, and under the general supervision of Program and Project Manager Danilo Sanchez, and Program and Project Supervisor Lisa Bilir. Mr. Aslam's Statement of Qualifications can be found in ORA's Company-Wide Report on the Results of Operations in this proceeding, A.14-07-006. Shanna Foley and Kerriann Sheppard serve as ORA legal counsels.

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## LABOR AND PENSION & BENEFITS

### A. INTRODUCTION

This report presents ORA's analysis and recommendations on Labor and Pension & Benefits Expenses. Golden State Water Company (GSWC) is requesting a total of \$18,631,048<sup>1</sup> in expenses in the Test Year 2016 for its various Pension and Benefits plans such as health insurance, annual incentive bonus, and pension plans. For its labor expenses, GSWC is requesting a total of \$36,005,035<sup>2</sup> in expenses in the Test Year 2016.

### B. SUMMARY OF RECOMMENDATIONS

ORA has carefully reviewed GSWC's request regarding its Labor and Pension & Benefits expenses and found several areas of concern. Based on its investigations and review, ORA made several recommendations that are discussed in detail in this report. In sum, ORA recommends the following:

Adjustments	ORA Recommendations	GSWC Request	Difference	Percent	
Addition of Savings Resulting from the position of Director of Procurement	█ █	█ █	█ █	█	█
Reduction of annual incentive bonuses	\$ 464,630	\$ 1,326,520	\$ (861,890)	-65%	
1% removal of Merit Increase and Reduction of Salaries	█ █	█ █	█ █	█	█
Removal of Postretirement Medical Benefit Plan (VEBA)	\$ -	\$ 221,199	\$ (221,199)	-100%	
Removal of Supplemental Executive Retirement Plan (SERP)	\$ -	\$ 1,204,414	\$ (1,204,414)	-100%	
Reduction in Group Health Insurance Expenses	\$ 6,343,216	\$ 7,543,188	\$ (1,199,972)	-16%	
Reduction in 401(k) Plan Expenses corresponding to salary reductions	\$ 926,430	\$ 1,380,688	\$ (454,258)	-33%	
Denial of New Medical Cost Balancing Account	Currently no Monetary Impact	-	-	-	

<sup>1</sup> Prepared Testimony of Gladys Farrow, Attachment 1.

<sup>2</sup> Prepared Testimony of Jenny Darney-Lane, Schedule 2.

### 1        **C. DISCUSSION – LABOR EXPENSES**

2        In order to forecast its labor expenses, GSWC begins the process by first identifying the  
3        individual employees and then applying the current level of their salaries. In cases where a  
4        position is currently vacant or being filled by a temporary employee, GSWC uses a mid-point of  
5        the salary grade. Next, GSWC develops allocation factors to allocate its labor costs between  
6        expenses and capital based on the latest recorded year allocations. Once the total expensed  
7        salaries are determined, GSWC then adds salary expenses incurred for its stand-by and call-out  
8        staff. This amount of expensed salary is then escalated using labor inflation factor, customer  
9        growth rate, and 1% merit increase. Finally, GSWC adds overtime costs and makes downward  
10       adjustments in its estimate for vacant positions.<sup>3</sup>

11       The total estimated labor expense is then split between Operations, Maintenance, and  
12       Administration categories based on the respective ratios for these categories as of year-end 2013.  
13       The labor cost of District Offices is allocated to the respective ratemaking areas based on the  
14       equivalent number of customers. The labor expenses in the General Office (GO) are captured in  
15       three Cost Centers - Corporate Support, Centralized Operations, and Billing & Cash Processing -  
16       and are allocated between GSWC water operations and its affiliates based on the four-factor  
17       allocations. Allocations of GO labor expenses within GSWC's ratemaking areas are based on the  
18       equivalent number of customers.

19       Based on the foregoing methodology, GSWC assessed its labor expenses across four major areas  
20       of its operations, namely General Office, Region 1, Region 2, and Region 3. More specifically,  
21       GSWC requests \$15,742,840 for General Office, \$5,083,028 for Region 1, \$6,570,045 for  
22       Region 2, and \$8,609,122 for Region 3 for Test Year 2016. These amounts reflect GSWC's  
23       overall request for its GO expenses; the subsequent allocations of these expenses among  
24       GSWC's various affiliates are discussed in ORA's Report on General Office.

25       GSWC's labor expense requests are as follows:

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<sup>3</sup> Prepared Testimony of Jenny Darney-Lane, pp. 6-8.

**Table-1: GSWC's Requested Labor Expenses**

Area	Test Year 2016
General Office	\$15,742,840
Region 1	\$5,083,028
Region 2	\$6,570,045
Region 3	\$8,609,122
<b>Total</b>	<b>\$36,005,035</b>

GSWC also requests seven new positions.<sup>4</sup> However, the associated salaries for these requested positions do not present additional labor expenses as the new positions involve reclassification of previously approved positions that are currently vacant.<sup>5</sup> ORA has carefully evaluated GSWC's methodology for estimating its labor expenses and found it to be reasonable with a few exceptions. The following sections address ORA's adjustments to GSWC's requests.

#### **1. Removal of Merit Increase**

GSWC used a 1% merit increase escalation factor to forecast its labor expenses from the recorded level of 2014 to that of the transition year-2015 and then the Test Year 2016. Although GSWC did not use the 1% merit increase escalation factor for the two subsequent Attrition Years - 2017 and 2018 - ORA recommends removing the 1% merit increase as it unduly inflates the transition-year and Test-Year values that in turn increases GSWC's estimates for the Attrition Years. GSWC claimed that such merit increases are assessed as a percentage of employees' base salaries and are used to form a pool of funds that are later used to award those employees who perform above the level expected of their respective positions. In addition to a merit increase escalation factor, GSWC also uses labor escalation factors per the ORA Energy Cost of Service

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<sup>4</sup> Prepared Testimony of GSWC's witness, Jenny Darney-Lane, p. 2.

<sup>5</sup> Email Correspondence received from GSWC's witness, Jenny Darney-Lane on February 24, 2015.

1 & Natural Gas and Water Branches' May 2014 Memoranda (ORA Memos). The company also  
2 applies an average customer growth factor. It is inappropriate to include this merit increase  
3 percentage on top of the wage escalation rates in determining GSWC's forecasted payroll  
4 expense.

5 ORA is aware that in the past the Commission considered this issue of merit increases and  
6 decided in GSWC's favor.<sup>6</sup> However, ORA would like to point out that given the current  
7 economic downturn and the fact that GSWC also proposes a parallel discretionary bonus  
8 program for its non-executive and non-managerial staff, which provides enough justification that  
9 the Commission should disallow the 1% merit increase. For example, ORA is currently  
10 recommending funds under other bonus and incentive compensation programs. Along with the  
11 comparable salaries this should be sufficient for encouraging and retaining GSWC's non-  
12 executive and non-managerial staff. Also note that GSWC has an elaborate bonus program for  
13 its executives and managers that is discussed separately in this report in section-4. For example,  
14 under the Pension & Benefit expenses, GSWC requests \$1,213,000 for the Test Year 2016 for a  
15 category titled "others."<sup>7</sup> GSWC's records indicate that in the recorded year 2013, this category  
16 included an amount of \$219,825 toward "Discretionary Bonus Program (non-managers)."<sup>8</sup> ORA  
17 recommends continuing this discretionary bonus program. Similarly, GSWC has additional  
18 elaborated bonus programs for its managers and executives in place which ORA addresses in this  
19 chapter.

20 Finally, GSWC's shareholders could always award additional bonuses and incentives to its  
21 employees, but not at the burden of its ratepayers. For the above reasons, ORA recommends  
22 disallowing the 1% merit increase adjustment.

## 23 **2. Removal of Customer Growth Factor from GSWC's Escalation Methodology**

24 ORA rejects GSWC's use of the customer growth factor to derive Test Year 2016 expense  
25 forecasts. The Commission's Rate Case Plan allows the application of customer growth factors

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<sup>6</sup> See Decision 10-11-035.

<sup>7</sup> Prepared Testimony of GSWC's witness, Gladys Farrow, p. 19.

<sup>8</sup> GSWC response to ORA's Data Request, AMX-003, Question-9.



1 in developing expense forecasts for the escalation/attrition years (in this case, 2017 and 2018),  
2 but does not specify or require such application in developing expense forecasts for the Test  
3 Year.<sup>9</sup> The Commission, in its San Jose Water Company GRC Decision, provides clear  
4 guidance on this issue:

5 ... a plain reading of D.07-05-062 shows that the Commission did not apply customer  
6 growth to test year expenses but instead applied the customer growth to expenses in  
7 escalation years following the test year. Therefore, the Commission has eliminated  
8 customer growth as a factor in all test year expenses.<sup>10</sup>

9  
10 In the same decision, the Commission presents the following Findings of Facts on the application  
11 of customer growth factor in developing Test Year estimates:

12 11. It is unreasonable to include customer growth escalation factors in test year expenses  
13 as test year expenses are escalated due to other factors.

14 12. D.07-05-062 applies customer growth to test year expense estimates to calculate  
15 escalation year expenses.<sup>11</sup>

16 Thus, consistent with prior Commission decisions, and ORA's operating expense estimates in  
17 this GRC, ORA removes GSWC's application of Customer Growth Factor from the labor  
18 expense calculations for Test Year 2016.

### 19 **3. Adding Potential Savings Resulting from the New Position of Director of** 20 **Centralized Procurement**

21 GSWC has added seven new positions. However, there is no rate impacts as these positions  
22 replace vacant positions previously approved by the Commission, and are now being filled under  
23 new titles.<sup>12</sup> GSWC's witness Jenny Darney-Lane provided the following summary of the  
24 proposed reclassification.<sup>13</sup>

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<sup>9</sup> D.07-05-062, Appendix-A, p. A-20.

<sup>10</sup> D.14-08-006, p. 26.

<sup>11</sup> D.14-08-006, p.120.

<sup>12</sup> Email Correspondence received from GSWC's witness, Jenny Darney-Lane on February 24, 2015.

<sup>13</sup> Prepared Testimony of Jenny Darney-Lane, p. 2.

**Table-2: Summary of GSWC-Proposed Reclassification.**

<b>Position #</b>	<b>New Title</b>	<b>Old Title</b>
5	Employee Relations Specialist	Assistant Legal Counsel
93 <sup>14</sup>	Director of Human Capital Management	VP Human Capital Management
195	Capital Program Manager	Preventive Maintenance Manager
181	Engineer Technician I	Office Assistant II
247	Director of Centralized Procurement	Administration Support Manager
447	Water Quality Analyst (GO)	Water Quality Analyst (Southwest)
598	Senior Network Administrator	ERP Developer

ORA has carefully analyzed the requested positions and found them reasonable. However, GSWC justified the re-classification of the Administration Support Manager to the Director of Centralized Procurement position by claiming that this reclassified position will be cost effective and result in bottom-line savings.<sup>15</sup> GSWC did not provide a quantitative analysis to support this claim.<sup>16</sup> In addition, GSWC may be establishing a new “Procurement Services Department” in the future although it has not requested one here.<sup>17</sup> The formation of a Procurement Services Department must be justified explicitly with proper cost/benefit analysis by GSWC for the Commission’s review in subsequent filings, such as in GSWC’s next GRC. By recommending approval of the requested position of Director Centralized Procurement, ORA does not imply that

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<sup>14</sup> GSWC’s witness Jenny Darney-Lane informed ORA via an email, dated February 23, 2015, that this position number was inadvertently listed as 95 instead of 93.

<sup>15</sup> Prepared Testimony of GSWC’s Denise Kruger, p. 11.

<sup>16</sup> GSWC response to ORA’s Data Request, AMX-001, Question-3.

<sup>17</sup> During a field trip to GSWC’s General Office, GSWC’s witness, Denise Kruger confirmed that the company would be forming a centralized Procurement Service Department.

1 it also agrees to the establishment of a Procurement Services Department. For the purpose of  
2 current GRC, ORA has only analyzed the merits of having a high-level procurement officer who  
3 can coordinate the procurement activities across the company's various regions.

4 ORA recommends that the new position of the Director of Centralized Procurement be accepted  
5 on the condition that the sizeable savings as claimed by the company is recognized. Therefore,  
6 ORA recommends a savings amount equal to at least 50% of the compensation paid to the new  
7 position of Director of Centralized Procurement which amounts to \*BEGIN CONFIDENTIAL  
8 [REDACTED] \*END CONFIDENTIAL. ORA finds this amount of recommended savings moderate.  
9 The 50% compensation adjustment is based on the expectations that ratepayers should not be  
10 footing a bill for a position that cannot contribute more benefit than its cost. In addition, ORA  
11 also recommends that in future GRC filings, GSWC be required to submit a report showing the  
12 quantified savings for its procurement functions.

#### 13 **4. Reduction of Base Salaries & Bonuses.**

##### 14 **a. Compensation of Executives and Officers:**

15 ORA has evaluated the levels of base salaries and various benefit programs currently in place for  
16 GSWC's executives, managers, and other staff. GSWC applies a Total Direct Compensation  
17 (TDC) methodology in order to determine the level of compensation for its executives and  
18 officers. The TDC is comprised of three compensation components:

- 19 • Base Salary
- 20 • Annual Cash Incentives (Short-term Incentive Program)
- 21 • Annual Equity Grants (Long-term Incentives Program)

22 GSWC witness Keith Switzer explains in his Prepared Testimony that GSWC's Compensation  
23 Committee consists of four members of its Board of Directors, and that on an annual basis the  
24 Compensation Committee reviews the executive compensation to assess whether the  
25 compensation is appropriate to continue to attract and retain talented and experienced  
26 executives.<sup>18</sup> He further adds that the Compensation Committee makes sure that compensation

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<sup>18</sup> Prepared Testimony of Keith Switzer, p. 3.

1 levels are adequately aligned to the interest of GSWC’s executives, its customers, and  
2 shareholders.<sup>19</sup>

3 BEGIN CONFIDENTIAL\*

[REDACTED]

[REDACTED]

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<sup>19</sup> Prepared Testimony of Keith Switzer, p. 4.

<sup>20</sup> American States Water Company’s stock ticker symbol is AWR; ORA uses this acronym in this chapter because the compensation studies frequently reference the company as AWR.

<sup>21</sup> GSWC Response to ORA’s Data Request, AMX-005-Follow up (Contains Confidential Information)

1

[REDACTED]

<sup>22</sup> \*\* BEGIN CONFIDENTIAL \*\*

[REDACTED]

\*\* BEGIN CONFIDENTIAL \*\*

<sup>23</sup> Pursuant to Mercer's Executive Remuneration Study dated December 17, 2008 (contains confidential info).

<sup>24</sup> Mercer's Executive Remuneration Study, p. 40 (Contains Confidential Information)

[illegible]

<sup>26</sup> PM&P's 2013 Executive Compensation Review dated January 14, 2014, p. 6 (Contains Confidential Information)

Journal Pre-proof

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[illegible]



[illegible]

15      b. Compensation of Managers and Other Employees:

16 As far as the salary levels for managers and other employees of GSWC are concerned, the  
17 company claims that they were established during the 1990s as a result of a study performed by  
18 its consultant Mercer.<sup>27</sup> \* BEGIN CONFIDENTIAL [REDACTED]

28 \*

20      END CONFIDENTIAL

21 On the other hand, \* BEGIN CONFIDENTIAL [REDACTED]

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

<sup>27</sup> GSWC's response to ORA's Data Request, AMX-001, Question 5.

<sup>28</sup> GSWC's response to ORA's Data Request, AMX-006, Question 5 (Contains Confidential Information)

1 [REDACTED] [REDACTED]  
[REDACTED]  
[REDACTED]  
[REDACTED] \* END

5 COFNIDENTIAL

6 As discussed above, GSWC failed to support the current salary levels for its managers. \*

7 BEGIN CONFIDENTIAL [REDACTED]  
[REDACTED]  
[REDACTED]  
[REDACTED]  
[REDACTED]  
[REDACTED]  
[REDACTED] \* END

14 CONFIDENTIAL

15 **c. GSWC's Shareholders Must Share Short-Term and Long-Term Incentives Costs**

16 GSWC executives' Short-term incentives and Long-term incentives are based on performance  
17 criteria that are related to both financial performance and customer satisfaction. For example,  
18 GSWC's 2013 Proxy Statement states the following:

19 We adopted a short-term cash performance incentive plan in order to motivate executives  
20 who participate in the plan to maximize our performance from a financial, operations and  
21 customer service perspective. We believe that the performance incentives set forth in our  
22 annual short-term cash incentive programs adopted pursuant to this plan will permit us to  
23 meet our objectives. **(GSWC's Proxy Statement-2013, p. 45)**

24 However, a closer look at the GSWC's Performance Incentive Plan reveals that it is heavily  
25 weighted toward the financial performance of the company, rather than customers' satisfaction.

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<sup>29</sup> GSWC's response to ORA's Data Request, AMX-006, Question 2 (Contains Confidential Information)

<sup>30</sup> Ibid.

<sup>31</sup> GSWC response to ORA's Data Request, AMX-006, Question 2 (Contains Confidential Information)

<sup>32</sup> Ibid.

1 Customers are typically concerned with higher rates and economic hardships. These factors are  
2 not taken into account at all in the executive performance incentive plan. For example, out of 13  
3 total Performance Measures only two are directly related to GSWC's customers and those two  
4 only address customer complaints. Therefore, it is not reasonable that GSWC's captive  
5 ratepayers should bear the entire burden of funding these compensation incentives. Note that  
6 there is a total of 16 Performance Measures; however, three of them are related to AWR's  
7 subsidiary, American States Utilities Services (ASUS).<sup>33</sup> Therefore, it appears that there is at  
8 least a 15% (2/13 x 100) weight given to GSWC's ratepayers in the areas of reducing customer  
9 complaints. This is the basis for ORA's recommendation that GSWC ratepayers should bear no  
10 more than 15% of the cost of the executive Performance Incentive Plan.

11 On the other hand, unlike GSWC executives, the Performance Measures used for GSWC's  
12 managers are strictly based on the operational efficiencies that tend to have the greatest influence  
13 on the quality of service for ratepayers.

14 Based on the foregoing discussion and facts, ORA makes the following recommendations  
15 regarding GSWC's salary and bonuses:

- 16 1) Base salaries, Short-term incentives, and Long-term incentives of GSWC's Executives  
17 and Officers should be based on year 2005 recorded levels and should be escalated using  
18 appropriate labor escalation rates to the Test Year 2016. As discussed earlier, \*BEGIN

19 CONFIDENTIAL\* [REDACTED]

[REDACTED]<sup>34</sup> \*END CONFIDENTIAL

- 21 2) The Base salaries of GSWC's various managers should be based on year 2005 recorded  
22 levels and should be escalated using appropriate labor escalation rates to the Test Year  
23 2016. However, notice that GSWC claims that its organizational structure has changed  
24 since 2005.<sup>35</sup> Thus, it is not practical to trace back the salaries associated with the current  
25 managers' position to the positions that would have existed in 2005. Therefore, ORA

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<sup>33</sup> See Appendix-A of this report for copy of the American States Water Company's Short-Term Incentive Program.

<sup>34</sup> ORA obtained 2005 compensation data from GSWC through Data Request AMX-008 (Confidential Response).

<sup>35</sup> GSWC response to ORA's Data Request, AMX-008, Question-2 (Confidential Response)

1 used the average reduction rate of 23.21%<sup>36</sup> that resulted due to the recommended  
2 reduction of GSWC executives' salaries to reduce the current salaries of the GSWC's few  
3 top managers. As discussed earlier, GSWC claims that since 2005, it has used market  
4 salary ranges as a guide, but relies primarily on a prospects skills, education, and  
5 experience as the basis for setting its managers' salaries. However, it failed to produce  
6 verifiable evidence to support these claims. For example, GSWC failed to produce the  
7 1990 Mercer study and contrary to its claims, did not follow its own procedures to  
8 perform comparative compensation studies for all of its new positions.<sup>37</sup>

- 9 3) GSWC's shareholders should bear 85% of the costs of the Short-term incentive and  
10 Long-term incentive compensations of AWR's executives. The captive ratepayers should  
11 not bear more than 15% of the costs of the incentive compensation programs.
- 12 4) The Commission should order GSWC to work jointly with ORA in developing  
13 methodology for selecting an appropriate Peer/Comparator Group or other similar and  
14 appropriate forecasting methods that would result in equitable and reasonable level of  
15 AWR executives' Total Direct Compensation in future rate cases. The Commission has  
16 in the past ordered similar joint efforts. For example, in the case of energy utilities, the  
17 Commission ordered ORA and Southern California Edison to work jointly to make  
18 design modifications to its Executives' Total Compensation Study (D.12-11-051,  
19 Ordering Paragraph #30).
- 20 5) GSWC should also develop new salary basis and ranges for its various managers and  
21 employees as the company currently claims that it has no such studies in its possession.  
22 The Commission should require that GSWC work with ORA when it develops or  
23 undertakes a new compensation study for its non-executive employees.

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<sup>36</sup> See ORA's workpapers: ORA Bonuses Stock Award-Officers and Managers for 2014 GRC, Tab: Escalation Factors (contains confidential information).

<sup>37</sup> Managers' salaries were reduced in the same average proportions as the Executives' salaries were reduced from the base-year 2014 back to the 2005 levels.

**d. Shifting of Employees' Salaries within the General Office.**

In its Report on General Office, ORA recommends re-assignment of the salaries of Environmental Quality Department employees from Centralized Operation Support to Billing and Payment Process cost centers. See ORA's Report on General Office for detailed discussion on this adjustment. The proposed ORA reassignments will create lower cost allocations of GO labor costs for GSWC's ratepayers.

**5. Pension and Benefits Expense**

GSWC currently has several individual programs under the expense category of Pension and Benefits. For example, besides the regular pension plan, GSWC also has its health insurance, annual incentive bonus, 401(k) Employer Contribution, and other similar benefits listed under this category. The following is a schedule from GSWC's workpapers that summarizes the requested amounts for the various programs under Pension and Benefits expense category. Note that 2015 is used as estimated transition-year to forecast the expenses for the Test Year 2016 and two Attrition Years 2017 and 2018.

**Table-4: GSWC's Pension & Benefits Requests.<sup>38</sup>**

	2015	2016	2017	2018
Employee Training Costs	\$ 271,270	\$ 275,300	\$ 279,000	\$ 282,300
Annual Incentive Bonus	1,287,880	1,326,520	1,345,040	1,351,280
Restricted Stock Units	1,235,920	1,318,950	1,337,450	1,342,700
Stock Option	0	0	0	0
Oth Misc Empl Benefits	968,909	984,400	998,800	1,011,200
Employee Relocation	26,592	27,000	27,400	27,800
Other Travel, Meals and Safety	198,758	201,700	204,600	207,200
	3,989,329	4,133,870	4,192,290	4,222,480
401K Employer Contribution	1,358,987	1,380,688	1,401,300	1,419,500
Insurance Empl Benefits	6,826,058	7,543,188	8,292,936	9,312,436
VEBA	110,552	221,199	230,965	202,706
SERP	1,229,696	1,204,414	1,238,108	1,278,833
Pension	4,064,705	3,759,946	3,384,958	3,027,609
Defined Contribution Plan	334,037	387,744	393,400	398,300
	13,924,035	14,497,178	14,941,667	15,639,384
<b>Total Pensions and Benefits</b>	<b>\$ 17,913,364</b>	<b>\$ 18,631,048</b>	<b>\$ 19,863,957</b>	<b>\$ ,864</b>

<sup>38</sup> Prepared Testimony of Gladys Farrow, Attachment 1.

1        **D. DISCUSSION – PENSION & BENEFITS EXPENSES**

2        GSWC offers a Defined Benefit Plan to its employees hired prior to January 1, 2011. Employees  
3        hired after that date are offered a Defined Contribution Plan. Therefore, as of 2011 GSWC has  
4        two separate Pension Plans in place.<sup>39</sup> For its Defined Benefit Plan, GSWC is requesting  
5        \$3,759,946, for the Test Year 2016 and for its Defined Contribution plan, GSWC is requesting  
6        \$387,744 for the Test Year.<sup>40</sup>

7        GSWC hired outside actuary Mercer to develop estimates for its two Pension Plans.<sup>41</sup> The  
8        annual expense for Pension Plans is calculated in accordance with the accounting guidance for  
9        employers' accounting for pension formerly known as Statement of Financial Accounting  
10       Standards (SFAS) No. 87 (Employers' Accounting for Pensions).<sup>42</sup> Mercer used a variety of  
11       actuarial assumptions such as discount rates, mortality rates, salary increase, inflation rates, etc.,  
12       to estimate Pension Plan expenses.<sup>43</sup> ORA has carefully analyzed these assumptions and finds  
13       them reasonable.

14       Pursuant to D.10-11-035 and D.13-05-011, GSWC has also established a two-way Pension  
15       Balancing Account that provides risk protection to both GSWC and its ratepayers in tracking the  
16       over- or under- collections between authorized pension expense estimates and the actual pension  
17       contribution payments. However, with switching its pension plan from a Defined Benefit Plan to  
18       the Defined Contribution Plan, GSWC has been able to mitigate its future risk as its pension  
19       liabilities are limited to the adequate contribution to support the Defined Contribution Plan.  
20       Therefore, ORA questions whether the Pension Balancing Account should continue. ORA  
21       recommends that the Commission require GSWC to provide a detailed, affirmative showing to  
22       justify the continuation of the Pension Balancing Account and order its discontinuance if such a  
23       burden is not met.

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<sup>39</sup> Prepared Testimony of Gladys Farrow, p. 2.

<sup>40</sup> Ibid.

<sup>41</sup> Prepared Testimony of Gladys Farrow, p. 3.

<sup>42</sup> Ibid.

<sup>43</sup> Prepared Testimony of Gladys Farrow, p. 4.

1 **1. Postretirement Medical Benefit Plan (VEBA Plan):**

2 GSWC offers postretirement medical benefits to those employees who were hired before January  
3 1995.<sup>44</sup> Employees hired after February 1995 are not offered these benefits. GSWC's actuary  
4 Mercer prepares the estimates for future years.<sup>45</sup> GSWC's requests \$221,199 for Test Year  
5 2016. Mercer estimated VEBA Plan costs based on SFAS No. 106: "Employers' Accounting for  
6 Postretirement Benefits Other than Pension."

7 GSWC customers have suffered through the recent great recession and are now just beginning to  
8 recover financially. Therefore, during the current economic hard times GSWC should not  
9 burden its captive ratepayers with the funding of such benefits that are offered to employees  
10 hired prior to 1995.<sup>46</sup>

11 In addition, in response to ORA's data requests AMX-003, Question 2(e), GSWC stated:

12 There is no program in place, providing retiree medical insurance benefits, for employees  
13 hired on and after February 1, 1995. In fact, this has created an issue of inequality  
14 amongst our employees and the benefits offered. This had produced and continues to  
15 produce an employee relation problem. It also has a negative impact on retention and  
16 recruitment. As the need to retain and attract new talent to GSWC arises, every  
17 competitive edge makes a difference. Providing equitable benefits to all employees  
18 increases this ability to attract and retain talent. Companies, including other Class A  
19 Utilities regulated by this Commission, and Water Agencies, that offer postretirement  
20 benefits to all of their employees gain an effective competitive advantage in the  
21 marketplace. **(GSWC's Response to ORA's Data Request, AMX-003, Question -2e)**

22 ORA notes that GSWC's response above fails to explain why GSWC deemed it necessary to  
23 award the plan to the employees hired before February 1995. Similarly, GSWC claims a few  
24 other Class-A water utilities might have similar postretirement plans, but fails to identify any.  
25 Even if this was the case, without analyzing the specific pension and benefits plans of other

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<sup>44</sup> Prepared Testimony of Gladys Farrow, p. 5.

<sup>45</sup> Prepared Testimony of Gladys Farrow, p. 6.

<sup>46</sup> According to California Budget Project (CBP), a nonpartisan, nonprofit organization that focuses solely on evaluating public policies and their impact on low- and middle-income Californians, the unemployment in California was record-high at the level of 8.7 percent which was higher than any point during or following the 2001 recession. Similarly, nearly 16% Californians---more than six-million people---had incomes below the federal poverty line in 2012, compared to 12.2% in 2006. See Appendix -C for the copy of the complete Report.

1 Class-A water companies, the Commission should not allow a wholesale authorization just  
2 because a few other Class-A water utilities have such benefit plans. Each utility has unique  
3 circumstances and the plans are results of employee bargaining agreements. Therefore, the  
4 Commission should not adopt a one-size-fit-all approach. ORA recommends that GSWC's  
5 shareholders fund these benefits, not GSWC's captive ratepayers.

## 6 **2. Supplemental Executive Retirement Plan (SERP):**

7 In addition to GSWC's pension plan and postretirement benefits, GSWC has yet another  
8 additional retirement benefit plan for its officers under the Supplemental Executive Retirement  
9 Plan (SERP).<sup>47</sup> GSWC explains that Internal Revenue Code (IRC) Sections 415 and 401(a) (17)  
10 were revised to limit certain benefits of top executives.<sup>48</sup> In order to keep the retirement benefits  
11 of its executive at the level prior to such revision, GSWC established its SERP.

12 ORA finds that by establishing SERP, GSWC effectively defeats the purpose of the IRC code  
13 sections, which were established to limit the amount of benefits that may be paid to participants  
14 under IRC Section 415 and the amount of employee/employer contribution under IRC Section  
15 401(a)(17). For example, a federal Joint Committee on Taxation issued a report titled,  
16 "GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986," in which the  
17 Committee explained that the purpose of the revised changes were to mitigate the greater tax-  
18 favored contributions by or on behalf of highly compensated employees without comparable  
19 participation by rank-and-file employees:

20 Congress was concerned that the rules relating to employer matching contributions and  
21 employee contributions under prior law encouraged employers to shift a greater share of  
22 the cost of retirement savings to employees. Congress was also concerned that the prior  
23 law nondiscrimination rules permitted greater tax-favored contributions by or on behalf  
24 of highly compensated employees without comparable participation by rank-and-file  
25 employees. Accordingly, Congress concluded that it was appropriate to revise the  
26 nondiscrimination rules for employer matching contributions and employee contributions  
27 in order more closely to achieve this goal.

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<sup>47</sup> Prepared Testimony of Gladys Farrow, p. 7.

<sup>48</sup> Ibid.



(General Explanation of the Tax Reform Act of 1986, Federal Joint Committee Report, page-645)

Based on ORA's analysis, ORA recommends that SERP benefits not be funded by ratepayers. GSWC's captive ratepayers are already footing the bill for GSWC's elaborate pension plan for its past and present executives. If GSWC wants to continue such benefits, they should be funded by its shareholders.

### 3. Group Health Insurance

GSWC provides all of its active employees and certain retirees medical, dental, and vision care benefits through a medical insurance plan. The plan is fully insured by Anthem Blue Cross of California. GSWC has requested health insurance amounts of \$7,543,000 for the Test Year 2016. GSWC's witness Gladys Farrow in her prepared testimony claims that GSWC used an average annual escalation factor of 11% to develop its estimates for future health insurance costs for its Preferred Provider Option of the Medical Plan, the HMO portion of the Medical Plan, and three Dental Insurance Options.<sup>49</sup>

However, a closer look at GSWC's workpapers revealed that GSWC has not used an average annual escalation factor of 11% for all three medical, dental, and vision plans. In response to ORA's data request AMX-003, Question 4(a), GSWC provided the information regarding various escalation rates it has used for its medical, dental, and vision insurance plans. The following table shows these rates.

**Table-5: Annual Escalation Rates Used in Various Insurance Plans**

Year	Medical Insurance	Dental Insurance	Vision Insurance	Life Insurance	EAP
2014	14.30%	12.10%	9.30%	1.60%	1.60%
2015	11.20%	8.40%	6.20%	1.50%	1.50%
2016	11.10%	5.50%	6.10%	1.60%	1.60%
2017	10.20%	6.20%	5.20%	1.40%	1.40%
2018	9.20%	5.60%	4.20%	1.20%	1.20%

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<sup>49</sup> Prepared Testimony of Gladys Farrow, p. 8.

1 In addition, GSWC did not offer any prepared testimony for its requested costs estimates for  
2 dental and vision plans. GSWC's requested health insurance amount of \$7,543,000 for Test  
3 Year 2016 is inclusive of not only the medical, dental, and vision plans, but also life insurance  
4 and the Employee Assisted Program (EAP).

5 GSWC's estimate of 11% annual increase in health insurance cost is also excessive. For  
6 example, in responding to ORA's data request AMX-003, Question-4(b), GSWC provided the  
7 following information in which it compares GSWC's most recent actual renewal increases to that  
8 of two major carriers, and the average renewal cost of more than 3,000 clients over the recent  
9 four years from GSWC's actuary consultant Mercer.

10 **Table-6: GSWC's Comparison of Renewal Increases**

	GSW	Carrier 1	Carrier 2	Mercer Survey
2010	2.9%	12.6%	11.3%	8.4%
2011	9.5%	9.4%	8.7%	7.7%
2012	3.5%	7.5%	9.1%	6.3%
2013	6.0%	9.0%	9.6%	3.0%
Composite	5.4%	9.6%	9.7%	6.3%
Note: Mercer Survey figures reflect the impact of plan design changes				

11  
12 The above schedule shows that GSWC on average has incurred an annual increase of 5.4% over  
13 the 2010-2013 period, while the market average (more than 3,000 clients) experiences a 6.3%  
14 average rate. The requested amount of 11% is therefore, excessive given the recent history. In  
15 her prepared testimony, GSWC's witness Gladys Farrow lists a few reasons such as increased  
16 utilization of prescription drugs, increased cost of medical technology, increased cost of  
17 hospitals, an aging population, the impact of Patient Protection and Affordable Care Act  
18 (PPACA), etc., to justify the use of an 11% increase. However, the witness fails to quantitatively  
19 translate any of these reasons into the proposed increase in the escalation rate. On the other  
20 hand, the actual and potential impacts of most of these reasons have already been captured over  
21 recent years in the renewal costs of premiums. For example, PPACA was signed into law on  
22 March 23, 2010. Thus, its potential impact should be duly reflected in the renewal rates for years  
23 2011, 2012, 2013, and 2014.

1 In addition, while clarifying its earlier response to ORA's data request AMX-003 (Question-4a),  
2 GSWC stated the following in an email correspondence on November 07, 2014:

3 Basically, the calculation is based on the difference between GSWC's cost increases and  
4 National Health Expenditures (NHE) over the past several years. As the exhibit shows,  
5 since 2009 GSW dollar cost increases have averaged about five percentage points above  
6 increases in NHE. Under the assumption that historical differences will continue into the  
7 future, this "delta" was applied to NHE projections through 2020 to estimate GSWC  
8 future trends.

9 (GSWC's Jenny Darney-Lane email dated November 7, 2014)

10 The above response confirms that GSWC has used the National Health Expenditure (NHE)  
11 forecast as a baseline and added the differences (i.e., "delta") by which its own medical  
12 expenditure cost was above the historic NHE expense levels. This delta is 5% in case of medical  
13 costs and 1.3% for the dental insurance expenditures. Using a national data base for the medical  
14 expenditures such as NHE, which is comprised of thousands of large and small companies, can  
15 serve as an example of an average medical cost. However, adding extra cost increases on the  
16 average is too excessive. A more reasonable approach would be to take GSWC's own historic  
17 average of 5.4% for medical expenditure over the recent four-year period (2010-2013) as used by  
18 GSWC's consultant Mercer and shown in Table-6 above, and use this 5.4% as an escalation  
19 factor for future years. However, GSWC first takes the NHE's projections for the future years,  
20 for example, 9.4% for year 2014 for medical insurance, and then increases the NHE projected  
21 rates by adding an extra 5% in the form of a "delta" to project a total medical insurance increase  
22 at 14.4% over its 2013 recorded values. Based on the same methodology, GSWC adds a 5%  
23 delta to the NHE's estimates of 6.1% for year 2016 to obtain an 11.1% escalation rate for the  
24 Test Year 2016. This excessive factor is unsupported and out of touch with the realities of the  
25 marketplace for medical insurance premiums.

26 ORA also conducted research into other recent articles and studies regarding health care cost.  
27 ORA found that medical cost inflation rates, if forecasted, are lower than the 11% requested by  
28 GSWC. For example, a recent annual survey by the global professional services company Tower  
29 Watson and the National Business Group Health indicated that in 2015, medical costs are

1 expected to increase by 4%.<sup>50</sup> Another article by the same source puts the estimates as high as  
2 5.7%, nowhere near the 11% increase requested by GSWC.<sup>51</sup>

3 The Commission has also routinely relied on economic data prepared by IHS Global Insight to  
4 ascertain the level of inflation. IHS Global Insight forecasts that healthcare costs will increase  
5 by 3.7%, 5.5%, 5.9%, 5.9%, and 5.3% in years 2014, 2015, 2016, 2017, and 2018 respectively.  
6 These health care inflation factors are still higher than the Consumer Price Index (CPI) inflation  
7 factors listed in ORA's Escalation Memo that incorporates projections prepared by IHS Global  
8 Insight, and are still significantly lower than the 11% requested by GSWC.

9 Based on the foregoing findings, ORA recommends that the Commission reject GSWC's 5% and  
10 1.3% adders on its medical health care and dental costs, respectively. ORA further recommends  
11 that GSWC's Medical, Dental, and Vision health care costs should be escalated based on IHS  
12 estimates of 3.7%, 5.5%, 5.9%, 5.9%, and 5.3% in years 2014, 2015, 2016, 2017, and 2018  
13 respectively. In the case of life insurance and EAP insurance estimates, ORA agrees with  
14 GSWC's use of the IHS Global Insight CPI escalation factors. Based on ORA's  
15 recommendations, the total cost estimates for GSWC's various line of insurance would be  
16 \$6,343,216 in Test Year 2016.

#### 17 **4. Special Request # 2: To Establish a New Medical Cost Balancing Account**

18 In order to support its Special Request #2 for establishment of a new Medical Cost Balancing  
19 Account (MCBA), GSWC stated that group medical insurance premiums continue to increase  
20 above CPI, while the Commission's Rate Case Plan only allows for one test year and two  
21 attrition years for expenses where the Pension and Benefit cost are escalated using the labor  
22 inflation factors.<sup>52</sup> GSWC adds that these labor inflation factors are historically much lower than  
23 the historic and forecasted increases in the medical premiums. GSWC also stated that the  
24 Commission has authorized the similar Medical Cost Balancing Accounts for a few other Class  
25 A water utilities.

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<sup>50</sup> See Appendix-B: Tower Watson Article on health care cost.

<sup>51</sup> Ibid.

<sup>52</sup> D. 07-05-062, Appendix, p. A-19.

1 Although GSWC is correct that under D. 07-05-062 the labor inflation rates are used for  
2 escalating medical costs in the attrition years, depending on the specific facts and details of the  
3 respective GRC cases, ORA has routinely recommended, and the Commission has allowed,  
4 inflation rates that were much higher than the labor inflation rates. For example, in its response  
5 to ORA's data request AMX-003, Question 4(d), GSWC acknowledged that since the Rate Case  
6 Plan was established, the Commission twice has authorized medical inflation factors that were  
7 more than the labor inflation factors. In addition, even in this current GRC, ORA recommends  
8 escalation rates for the group health care that are above the labor inflation factors. As discussed  
9 earlier under the Group Health Insurance section, based on ORA's review of the GRC filing and  
10 its own investigation of independent studies, ORA recommends the more reasonable level of  
11 inflation rates for the group health costs. Therefore, while ORA uses D.07-05-062 as a  
12 guideline; it also takes into consideration the current trends and recent information in  
13 formulating its recommendation. Often, ORA's recommendation for escalating health care costs  
14 may be higher than what would have resulted from the prescribed use of labor inflation factors  
15 under D.07-05-062. Thus, ORA's recommended escalation factors more than adequately protect  
16 GSWC from increases in medical costs. Therefore, ORA recommends that the Commission  
17 reject GSWC's request to establish a new Medical Cost Balancing Account as the current  
18 ratemaking procedures in place are adequate to take into consideration possible changes in the  
19 trend of medical costs, and result in appropriate authorized escalation rates.

20 In addition, allowing this type of automatic cost recovery mechanisms in the form of cost  
21 balancing accounts inherently reduces the risk of doing business for the utility. Therefore, any  
22 decisions regarding authorizing such assurances regarding cost recovery must include the  
23 consideration of lowering the utility's rate of return in the cost of capital proceedings that are  
24 scheduled to be filed by GSWC in 2016. The lowering of business risk must be reflected in a  
25 reduced rate of return. The Commission, therefore, should not separate these two inherently  
26 inseparable decisions when considering balancing account treatment of utility costs that are  
27 under the control of the company. Any such decision must also have a compensating reduction  
28 in the utility's cost of capital due to the reduced risk and must be considered in the cost of capital  
29 proceedings. Therefore, GSWC must present any such request for cost recovery assurance along  
30 with downward adjustment in its rate of return to reflect lowered business risks. GSWC has not  
31 done so in this case. Therefore, without the downward adjustment in GSWC's rate of return, an

1 increase in the cost recovery assurance would be unreasonable and unfair for GSWC's captive  
2 ratepayers.

3 Finally, GSWC certainly has the capability to shop around and get the best rates for its health  
4 insurance services. Therefore, allowing a balancing account will negatively impact GSWC's  
5 motivations and incentives to seek least-cost options. Based on the forgoing discussion, ORA  
6 recommends that the Commission reject GSWC's request for the Medical Cost Balancing  
7 Account.

## 8 **5. 401(k) Investment Incentive Plan**

9 GSWC provides an investment incentive 401(k) program that would allow employees to invest  
10 up to a specified percentage of their pay. Employees can defer up to 20% of their salary into a  
11 401(k) plan on a pre-tax basis. GSWC matches 100% of the employee deferrals up to 3% of the  
12 eligible pay and 50% of the employee deferrals between 3% and 6% of the eligible pay,<sup>53</sup> thus  
13 matching a maximum of 4.5% of its employees' contributions. GSWC is requesting \$1,381,000  
14 for the Test Year 2016. GSWC states that 401(k) costs are increased mainly due to salary costs  
15 and changes to the 401(k) plan mandated by the Economic Growth and Tax Relief  
16 Reconciliation Act of 2001 (EGTRRA). The EGTRRA has increased the maximum allowable  
17 pre-tax deferral from \$16,500 in 2011 to \$17,500 in 2014, and allows an additional "catch up"  
18 deferral of up to \$5,500 in 2014 for the employees who are 50 years of age or older.<sup>54</sup>

19 As discussed earlier, ORA made recommendations for GSWC's salary reductions. Therefore,  
20 the reduced salaries will impact the respective levels of employees' contribution and GSWC's  
21 matching amounts. Currently, GSWC's workpapers show that an overall company matching  
22 amount of \$1,591,023.46 was incurred in 2013.<sup>55</sup> Whereas the associated labor costs (base  
23 salary plus overtime) was \$40,963,416.<sup>56</sup> Because ORA is recommending various changes in the  
24 base salary amounts for GSWC's employees, ORA recommends a pro-rated amount of 401(k)

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<sup>53</sup> Prepared Testimony of Gladys Farrow, p. 13.

<sup>54</sup> GSWC's Gladys Farrow Prepared Testimony, p. 13.

<sup>55</sup> GSWC's workpapers: Excel file titled, Benefits Projections for Rate Case-Application, Tab, 401k November 2013 (contains confidential information).

<sup>56</sup> GSWC Response to ORA Data Request AMX-007.

1 for the Test Year 2016 in the amount of \$1,246,628 based on the pro-rated ratio that existed in  
2 year 2013 between the base salary and 401(k) expenses. The expensed portion of these expenses  
3 is \$926,430 for the Test Year 2016.

4 In addition, GSWC forecasted its 401(k) expenses based on the following escalation factors:  
5 3.0%, 2.5%, and 1.6% for the years 2014, 2015, and 2016, respectively. GSWC states that the  
6 3% escalation rate in year 2014 is comprised of a 1.5% cost of living increase and 1.5% as merit  
7 increase. For all subsequent years, GSWC used labor inflation rates and added a 1% of merit  
8 increase. However, in its response to ORA's data request AMX-004, Question 5, GSWC stated  
9 that it inadvertently did not add a 1% merit increase for the years 2016, 2017, and 2018.

10 ORA recommends that for 401(k) expenses, GSWC should use the labor escalation factors and  
11 labor related expenses, and without any additional adjustment for merit increase, consistent with  
12 ORA's recommendation to disallow merit increases. ORA, therefore, recommends the use of the  
13 following escalation factors: 1.6%, 1.5%, and 1.6% for years 2014, 2015, and 2016, respectively  
14 pursuant to the ORA Energy Cost of Service & Natural Gas and Water Branches' May 2014  
15 Memoranda (ORA Memos).

## 16 **6. Employee Training Costs**

17 GSWC requests \$275,300 for Test Year 2016 to fund employee training needs. GSWC provides  
18 a variety of employee training internally but argues that some essential training cannot be  
19 provided internally. For example, GSWC indicated in its response to ORA's data request AMX-  
20 003, Question 8(b), that several classes such as Cal/OSHA Safety, CA Hazardous Waste, EPA,  
21 Department of Transportation, and California Division of Drinking Water compliance are offered  
22 externally and are essential for its employees. GSWC also lists a host of other trainings that are  
23 provided externally such as Asbestos Cement Pipe Refresher courses, Accident Investigation  
24 Training, Fall Protection, Respiratory Protection, etc. Based on the review of the information  
25 provided by the company, ORA found GSWC's estimates reasonable.

## 26 **7. Other Pension & Benefits Expenses**

27 GSWC requests \$1,213,000 in Test Year 2016 for various expenses listed under the Pension &  
28 Benefit expense category, titled "Other Pension & Benefits Expenses." GSWC explains that  
29 these costs are comprised of several smaller items such as employee discretionary bonus  
30 programs, actuarial services, stand-alone audits of GSWC's pension and other post-retirement



1 plans, and travel and lodging associated with employee training. GSWC's estimates are based  
2 on last five years' average, which is then escalated using CPI escalation factors. Based on the  
3 review of the information provided by the company, ORA found GSWC's estimates reasonable.

#### 4 **E. CONCLUSION**

5 ORA makes several recommendations regarding GSWC's request for its labor, pension, and  
6 benefit expenses. For example, ORA recommends removal of the 1% merit increase as GSWC  
7 already has discretionary bonus programs in place. Similarly, ORA recommends adding  
8 operational savings resulting from having a centralized position of Director of Procurement.  
9 ORA also recommends reducing the salaries of GSWC's executives and a few of its top  
10 managers as GSWC's current records failed to provide reasonable support for the current  
11 amounts of salaries and the associated bonuses. In addition, ORA recommends reducing the  
12 requested level of GSWC's Group Health Plan as GSWC lacks the reasonable support for the  
13 higher 11% increase in its premiums. ORA also recommends that due to the current economic  
14 downturn the cost burden for GSWC's employee benefit programs such as Postretirement  
15 Medical Benefit Plan (VEBA) and Supplemental Executive Retirement Plan (SERP) should be  
16 removed off the captive ratepayers. In addition, ORA recommends rejecting GSWC's request  
17 for the Medical Cost Balancing Account as the Commission routinely allows above traditional  
18 labor escalation factors for the expenses related to the utilities' medical insurance costs.



1

**APPENDIX –A:**

2

American States Water Company 2013 Short-Term Incentive Program

**AMERICAN STATES WATER COMPANY**  
**2013 SHORT-TERM INCENTIVE PROGRAM**

**1. *Purpose of 2013 Short-Term Incentive Program***

American States Water Company, a California corporation, (the “**Corporation**”) has adopted the American States Water Company Performance Incentive Plan (the “**Plan**”) to promote the success of the Corporation by (a) motivating executives selected to participate in the Plan to maximize the performance of the Corporation both from a financial perspective and in serving its customers and (b) rewarding them with cash Objective Bonuses directly related to such performance. The Corporation’s board of directors recognizes that the ability of the Corporation and its subsidiaries to attract capital at a low cost is based on its financial performance and that the Corporation’s customers benefit through its ability to attract low cost capital. This 2013 Short-Term Incentive Program (the “**2013 STIP**”) sets forth the names of the individuals selected to be Participants who are eligible to earn Objective Bonuses under the Plan for the 2013 calendar year and the applicable Business Criteria, Additional Objective Criteria, Performance Targets, and Payout Percentages for the 2013 calendar year. The 2013 STIP also provides for Discretionary Bonuses, which when added to the Objective Bonuses under the Plan, equal the Aggregate Bonuses payable under the 2013 STIP for the 2013 calendar year.

**2. *Term of 2013 STIP***

The Performance Period covered by the 2013 STIP (the “**Term**”) began on January 1, 2013 and will end on December 31, 2013.

**3. *Relationship to American States Water Company Performance Incentive Plan***

The Objective Bonuses based on the Business Criteria (including any Objective Bonuses reduced for failure to satisfy any Additional Objective Criteria) payable under Awards granted under the 2013 STIP are granted under the authority of the Plan and are subject to all of the terms and conditions of the Plan, as it may be amended from time to time, and any rules adopted by the Committee in accordance with the terms of the Plan, as such rules are in effect from time to time. The Discretionary Bonuses and the Objective Bonuses based solely on satisfaction of the Additional Objective Criteria are granted under the general authority of the Compensation Committee to determine the compensation payable to Executives.

**4. *Definitions***

Capitalized terms used and not otherwise defined herein have the meanings set forth in the Plan. In addition, the following phrases shall have the meanings specified below:

“**Additional Objective Criteria**” means Maintenance Expenses-RU and Supplier Diversity Utilization-RU.

“**Adjusted EPS - ASUS**” means the EPS of ASUS for 2013 adjusted to remove the general office allocation to ASUS related to any transaction fees and/or gain or loss on sale

recognized in the financial statements in 2013 associated with a sale of any of the Corporation's business units or the acquisition of any new businesses.

**"Adjusted EPS - AWR Consolidated"** means the Corporation's EPS for 2013 adjusted to remove any transaction fees and/or gain or loss on sale recognized in the financial statements in 2013 associated with a sale of any of the Corporation's business units or the acquisition of any new businesses.

**"Adjusted EPS - Regulated Utilities"** means the sum of the EPS of each of the Regulated Utilities for 2013 adjusted to remove any transaction fees and/or gain or loss on sale recognized in the financial statements in 2013 associated with a sale of any of the Corporation's business units or the acquisition of any new businesses.

**"Aggregate Bonus"** means the combination of a Participant's Objective Bonus and his or her Discretionary Bonus.

**"ASUS"** means American States Utility Services, Inc., a California corporation, and wholly owned subsidiary of the Corporation, and its wholly owned subsidiaries.

**"Award Agreement"** means a written agreement setting forth the material terms and conditions of the Award as determined by the Committee consistent with the express limitations of the Plan and the 2013 STIP.

**"Base Salary"** means the Participant's rate of annual base pay on the date the Committee approves the Business Criteria, the Additional Objective Criteria and Performance Targets.

**"Board of Directors"** means the Corporation's board of directors.

**"Budget" or "Budgeted"** means in the case of Adjusted EPS for the Corporation, the Regulated Utilities or ASUS, as the case may be, the projected Adjusted EPS for 2013 as set forth in the Operating Budget.

**"Business Criteria"** means Adjusted EPS-AWR Consolidated, Adjusted EPS- Regulated Utilities, Adjusted EPS-ASUS, Customer Complaints to DPH, Customer Complaint Standards-RU, Capital Expenditures-Total-RU, Capital Investments-Advice Letter Projects-RU, OSHA Recordable Work Incidents-RU, SOX Deficiencies-RU, SOX Deficiencies-ASUS, Economic Value Added-Price Redeterminations, CAS Waiver, Satisfaction of Customers (CPARS)-ASUS, and Satisfaction of Customers (SBU)-ASUS.

**"CAB"** means the CPUC Consumer Affairs Branch.

**"CAS"** means U.S. government Cost Accounting Standards.

**"CAS Waiver"** means obtaining by the end of 2013 a specific waiver from the U.S. government Contracting Officer(s) from requirements of CAS for ASUS subsidiary contracts where CAS is not categorically waived.

**“Capital Expenditures - Total - RU”** means the dollar amount of capital expenditures for 2013 for the Regulated Utilities.

**“Capital Investments - Advice Letter Projects - RU”** means the number of advice letter capital expenditure projects authorized by the CPUC for GSWC that were completed in 2013.

**“Committee”** means the Compensation Committee of the Board of Directors.

**“CPUC”** means the California Public Utilities Commission.

**“Customer Complaint Standards - RU”** means the number of complaints on all matters on GSWC received by CAB in 2013 divided by the average number of customers served by GSWC during 2013.

**“Customer Complaints to DPH”** means the number of water quality, pressure and service complaints received from customers by GSWC during 2013 that are reported to the California Department of Public Health by GSWC.

**“Discretionary Bonus”** means a bonus payable to a Participant based on that Participant’s Individual Performance Measures.

**“Economic Value Added - Price Redeterminations”** means the issuance of a contract modification/s during calendar 2013 for a permanent price redetermination/s resulting in the receipt of no less than 50% of the amount requested (O&M and R&R in total) for Contracts 1, 2 and 3.

**“EPS”** means fully diluted earnings per share as reported in the Corporation’s consolidated financial statements for 2013.

**“GSWC”** means Golden State Water Company, a California corporation and wholly owned subsidiary of the Corporation.

**“Individual Performance Measures”** means the criteria or goals utilized to determine the amounts of each Participant’s Discretionary Bonus.

**“Maintenance Expenses - RU”** means amounts spent on planned and unplanned non-labor related maintenance expenses for the water segment of GSWC during 2013 as determined in accordance with generally accepted accounting principles.

**“Objective Bonus”** means a bonus based on the degree of achievement of the Performance Targets for the Business Criteria (including any Objective Bonuses reduced for failure to satisfy any Additional Objective Criteria) and solely for the Additional Objective Criteria.

**“Operating Budget”** means the Company’s operating budget for 2013 as presented to the Board of Directors at its January 28-29, 2013 meeting.

**“OSHA Recordable Work Incidents - RU”** means the number of work-related injuries and illnesses as reported on the OSHA Form 300 for GSWC.

**“Payout Percentage”** means the percentage of a Participant’s Target Aggregate Bonus that is payable based on the degree of satisfaction of a Performance Target or the Individual Performance Measures.

**“Performance Measures”** means the Business Criteria, the Additional Objective Criteria and Individual Performance Measures.

**“Performance Target”** means a specific goal established by the Committee with respect to the Business Criteria or the Additional Objective Criteria as set forth in Section 6.

**“Regulated Utilities”** means GSWC and any other utility acquired by the Corporation which is designated a “regulated utility” by the Committee.

**“Satisfaction of Customers (CPARS) – ASUS”** means an overall rating of at least satisfactory for each ASUS contract (18.0) and an improvement in the overall rating for at least three of the ASUS contracts with the U.S. government as evaluated through the Federal Government’s Contractor Performance Assessment Reporting System.

**“Satisfaction of Customers (SBU) - ASUS”** means meeting the small business utilization targets for the commercial subcontracting plan at ASUS subsidiaries. The six categories include 1) Service Disabled Veteran-owned, Small Business, 2) Veteran-owned Small Business, 3) Historically Underutilized Business Zones, 4) Women-owned small business, 5) Small Disadvantaged Business and 6) Small Business.

**“SOX”** means the Sarbanes-Oxley Act of 2002.

**“SOX Deficiencies - ASUS”** means the number of “control deficiencies” (each a “CD”), “significant deficiencies” (each an “SD”) and “material weaknesses” (each a “MW”) reported for ASUS in the independent auditor’s report for 2013 pursuant to Section 404 of SOX.

**“SOX Deficiencies - RU”** means the number of CDs, SDs and MWs reported for the Regulated Utilities in the independent auditor’s report for 2013 pursuant to Section 404 of SOX.

**“Supplier Diversity Utilization - RU”** means the percentage reported by GSWC to the CPUC annually by March 1 in its General Order 156 Compliance Filing. The percentage is calculated by taking GSWC’s total procurement dollars for the reporting period with CPUC qualified women-owned, minority-owned, and disabled veteran-owned business enterprises divided by GSWC’s total procurement dollars (net of exclusions allowed under the General Order 156 Compliance Filing for the reporting period, such as payments for purchased water, purchased power, pump taxes, income taxes, franchise fees, and postage).

**“Target Aggregate Bonus”** means the amount of bonus that would be payable if each of the Performance Targets were met at the targeted level and the Participant’s Individual Performance Measures were met at the targeted level.



**5. *Participation and Individual Awards***

The individuals who have been selected as Participants in the 2013 STIP are set forth below together with the amount of their Target Aggregate Bonuses as a percentage of Base Salary:

	<b>Participant</b>	<b>Target Aggregate Bonus</b>
<b>GSWC Officers</b>		
<b>Administrative and General</b>	Robert J. Sprowls	50%
	Eva G. Tang	25%
	Gladys M. Farrow	20%
<b>Operations</b>	Denise L. Kruger	25%
	Patrick R. Scanlon	20%
	William C. Gedney	20%
	Shengder D. Chang (David)	20%
	Diane D. Rentfrow	20%
	Bryan K. Switzer (Keith)	20%
<b>ASUS Officers</b>		
	McClellan Harris III (Bud)	25%
	Granville R. Hodges, Jr. (Rusty)	20%
	James B. Gallagher	20%
	James C. Cotton III	20%

For purposes of this 2013 STIP, the GSWC officers will be divided into (1) Administrative and General Officers and (2) Operations Officers.

The Corporation will enter into an Award Agreement with each Participant that (a) describes his or her Individual Performance Measures and sets forth his or her Target Aggregate Bonus, (b) sets forth his or her threshold, target and maximum Performance Targets and (c) incorporates the terms and conditions of the Plan and this 2013 STIP by reference. The Target Aggregate Bonus amount set forth in each Participant's Award Agreement shall represent the aggregate amount of up to three separate bonuses: an Objective Bonus (under the Plan, including an Objective Bonus that may be reduced if any Additional Objective Criteria is not satisfied), an Objective Bonus based solely on satisfaction of Additional Objective Criteria and a Discretionary Bonus.

**6. *Performance Targets for Objective Bonuses***

The threshold, target and maximum Performance Targets for the 2013 STIP are set forth in Exhibit A to this 2013 STIP.

## **7. *Determination of Participants' Aggregate Bonuses***

The Aggregate Bonus payable to each Participant shall be determined on the basis of the extent to which the Performance Targets for the Business Criteria, the Additional Objective Criteria and that Participant's Individual Performance Measures are achieved. The amount of Aggregate Bonus payable is equal to the amount of the Target Aggregate Bonus multiplied by the sum of the Payout Percentages for each of the Performance Measures as determined pursuant to the tables in (a) Section B of Exhibit A for Participants that are Administrative and General Officers employed by GSWC, (b) Section C for Participants that are Operations Officers employed by GSWC and (c) Section D for Participants employed by ASUS.

As soon as practicable following the end of the Term of the 2013 STIP and the completion of the independent auditor's report for 2013, the Committee shall determine the extent to which the Performance Targets for the Business Criteria and Additional Objective Criteria are achieved and the extent to which the Individual Performance Measures are achieved, and determine the Payout Percentage for each of the Performance Measures. In order for a Participant to receive any payment with respect to the Participant's Discretionary Bonus, the Participant must meet the standards established for the Participant's position, which standards shall be one of the components of the Participant's Individual Performance Measures. The determination of whether the standards established for the Participant's position are achieved shall be made by the Committee, which (other than for the Company's President and Chief Executive Officer) determination shall be based on the recommendations of the President and Chief Executive Officer or other direct supervisor of the Participant.

For levels of achievement between threshold and maximum, the Committee shall determine the Payout Percentage by interpolation, except for the Maintenance Expenses-RU metric. Subject to Section 8 below, the Aggregate Bonus for each Participant shall be the sum of the Payout Percentages determined with respect to each Performance Measure multiplied by the amount of Participant's Target Aggregate Bonus.

## **8. *Payment of Accounts***

At the time the Committee makes the determinations described in Section 7, it shall certify, in accordance with Section 4.8 of the Plan, the amounts of the Objective Bonuses payable to Participants. The Committee shall, at the same time, determine the amount of the Discretionary Bonus payable to Participants. Payment of such bonuses (the Aggregate Bonuses) shall be made as soon as practicable following the Committee's determination and certification, but in no event later than December 31, 2013.

Notwithstanding the foregoing, any Objective Bonus otherwise payable to any Participant under this 2013 STIP shall be subject to the adjustments, limitations (including the dollar limitation under Section 4.3 of the Plan), Committee's discretionary authority to make downward adjustments and other terms and conditions set forth in the Plan. Any Discretionary Bonus otherwise payable under this 2013 STIP shall be subject to any adjustments, limitations, upward or downward adjustments in amounts and any other terms or conditions that the Committee may impose in its sole discretion.

**9. *Effect of Termination of Employment***

Except as otherwise provided in an employment agreement, memorandum of understanding, other contract between a Participant and the Corporation or one of its Subsidiaries, or by the Committee in its sole discretion, the bonuses payable under a Participant's Award will be forfeited, and the Participant will not be entitled to any bonus payments with respect to such Award if the Participant ceases to be employed by the Corporation or one of its Subsidiaries for any reason prior to the date the bonus payments under the 2013 STIP are paid to Participants.

**10. *Recoupment of Bonuses***

Any payment of an Objective Bonus, Discretionary Bonus or Aggregate Bonus under this 2013 STIP is subject to recoupment pursuant to the Corporation's Policy Regarding the Recoupment of Certain Performance-Based Compensation Payments as in effect from time to time, or as otherwise be required by law and a Participant shall promptly make any reimbursement requested by the Board of Directors or the Committee pursuant to such policy with respect to any such bonuses. Further, each Participant shall agree, by accepting an Award under the 2013 STIP and executing an Award Agreement, that the Corporation and/or any of its affiliates may deduct from any amounts it may owe the Participant from time to time (such as wages or other compensation) any and all amounts the Participant is required to reimburse the Corporation pursuant to such policy with respect to the Award.



# EXHIBIT A

## 2013 STIP PERFORMANCE TARGETS AND PAYOUT PERCENTAGES

### A. PERFORMANCE TARGETS FOR OBJECTIVE BONUSES

Performance Measure	Performance Targets		
	Threshold	Target	Maximum
Adjusted EPS - AWR Consolidated	80% Budget	100% Budget	120% Budget
Adjusted EPS - Regulated Utilities (RU)	80% Budget	100% Budget	120% Budget
Adjusted EPS - ASUS	80% Budget	100% Budget	120% Budget
Customer Complaints to DPH	400 or fewer	330 or fewer	300 or fewer
Customer Complaint Standards - RU	Rate of Complaints to the CAB $\leq$ 0.1%	Rate of Complaints to the CAB $\leq$ 0.043%	Rate of Complaints to the CAB $\leq$ 0.03%
Capital Expenditures - Total - RU	$\geq$ \$85 million	$\geq$ \$106 million	$\geq$ \$119.7 million
Capital Investments - Advice Letter Projects - RU	13 Projects Completed	15 Projects Completed	16 Projects Completed
Maintenance Expenses - RU	$\geq$ \$9.6 million	$\geq$ \$10.8 million and $\leq$ \$11.8 million	N/A
Supplier Diversity Utilization - RU	$\geq$ 13%	$\geq$ 14%	$\geq$ 15%
OSHA Recordable Work Incidents - RU	32	30	28
SOX Deficiencies - RU	No MW, No SD & No more than 12 CDs	No MW, No SD & No more than 7 CDs	No MW, No SD & No more than 5 CDs
SOX Deficiencies - ASUS	No MW, No SD & No more than 5 CDs	No MW, No SD & No more than 3 CDs	No MW, No SD & No more than 1 CD
Economic Value Added - Price Redeterminations	Issuance of a contract modification during calendar 2013 for a permanent price redetermination resulting in the receipt of no less than	Issuance of contract modifications during calendar year 2013 for permanent price redeterminations resulting in the receipt of no less	Issuance of contract modifications during calendar year 2013 for permanent price redeterminations resulting in the

Performance Measure	Performance Targets		
	Threshold	Target	Maximum
	50% of the amount requested (O&M and R&R in total) for Contract 1	than 50% of the amount requested (O&M and R&R in total) for Contracts 1 and 2	receipt of no less than 50% of the amount requested (O&M and R&R in total) for Contracts 1, 2 and 3
CAS Waiver	N/A	3 Contracts	N/A
Satisfaction of Customers (CPARs) - ASUS	An overall rating of at least satisfactory (score of 18) for each ASUS contract with the U.S. government and an improvement in the overall rating for at least two of these contracts	An overall rating of at least satisfactory for each ASUS contract with the U.S. government and an improvement in the overall rating for at least three of these contracts	An overall rating of at least satisfactory at each ASUS contract with the U.S. government and an improvement in the overall rating for at least four of these contracts
Satisfaction of Customers (SBU) - ASUS	4 categories	5 categories	6 categories

**B. PAYOUT PERCENTAGES FOR PERFORMANCE MEASURES - GSWC ADMINISTRATIVE AND GENERAL OFFICERS**

Performance Measure	Payout Percentage		
	Threshold	Target	Maximum
Adjusted EPS - AWR Consolidated	10%	20%	30%
Adjusted EPS - Regulated Utilities <sup>(1)</sup>	9%	18%	24%
Customer Complaints to DPH	1.5%	5%	6%
Customer Complaint Standards - RU	1%	2%	3%
Capital Expenditures - Total - RU	5%	12%	17%
OSHA Recordable Work Incidents – RU	1%	3%	5%
SOX Deficiencies – RU	2.5%	5%	7.5%
Adjusted EPS - ASUS	5%	10%	15%
SOX Deficiencies – ASUS	2.5%	5%	7.5%
Objective Bonus Total	37.5%	80%	115%
Individual Performance Measure (Discretionary Bonus)	12.5%	20%	35%
Aggregate Bonus	50%	100%	150%

(1) For the Adjusted EPS - Regulated Utilities Performance Measure, if GSWC fails to achieve a Supplier Diversity Utilization of at least 14%, the payout will be reduced by 3% for each of Threshold, Target and Maximum.

**C. PAYOUT PERCENTAGES FOR PERFORMANCE MEASURES - GSWC OPERATIONS OFFICERS**

Performance Measure	Payout Percentage		
	Threshold	Target	Maximum
Adjusted EPS - AWR Consolidated	10%	20%	30%
Adjusted EPS - Regulated Utilities (RU)	10%	20%	30%
Customer Complaints to DPH	1.5%	5%	6%
Customer Complaint Standards - RU	1%	2%	3%
Capital Expenditures -Total - RU	6%	12%	18.5%
Capital Investments - Advice Letter Projects - RU	1.5%	4%	6%
Maintenance Expense - RU	2.5%	5%	5%
Supplier Diversity Utilization - RU	1%	3%	4%
OSHA Recordable Work Incidents - RU	1.5%	4%	5%
SOX Deficiencies - RU	2.5%	5%	7.5%
Objective Bonus Total	37.5%	80%	115%
Individual Performance Measure (Discretionary Bonus)	12.5%	20%	35%
Aggregate Bonus	50%	100%	150%

**D. PAYOUT PERCENTAGES FOR PERFORMANCE MEASURES - ASUS**

Performance Measure	Payout Percentage		
	Threshold	Target	Maximum
Adjusted EPS - AWR Consolidated	10%	20%	30%
Adjusted EPS - ASUS	17.5%	30%	40%
SOX Deficiencies - ASUS	2.5%	5%	7.5%
Economic Value Added - Price Redeterminations	5%	12.5%	20%
CAS Waiver	N/A	5%	5%
Satisfaction of Customers (CPARS) - ASUS	1.5%	5%	7.5%
Satisfaction of Customers (SBU) – ASUS	1%	2.5%	5%
Objective Bonus Total	37.5%	80%	115%
Individual Performance Measure (Discretionary Bonus)	12.5%	20%	35%
Aggregate Bonus	50%	100%	150%

1

**APPENDIX –B:**

2

Tower Watson Article on health care cost





## **U.S. Employers Expect Health Care Costs to Rise 4% in 2015**

### **Companies plan to continue subsidizing and managing benefits while taking aggressive action to keep costs down**

August 20, 2014 | UNITED STATES

**ARLINGTON, VA, August 20, 2014** — U.S. employers expect a 4% increase in 2015 health care costs for active employees after plan design changes, according to global professional services company Towers Watson (NYSE, NASDAQ: TW). If no adjustments are made, employers project a 5.2% growth rate, putting absolute cost per person for health care benefits at an all-time high. Despite this cost trend, most (83%) employers consider health benefits an important element of their employee value proposition, and plan to continue subsidizing and managing them for both full-time and part-time active employees, according to the 2014 Towers Watson Health Care Changes Ahead Survey. They are, however, continuing to rethink company subsidies for spouses and dependents.

Of particular concern on the cost front is the Patient Protection and Affordable Care Act's excise tax,\* which goes into effect in 2018. Nearly three-quarters (73%) of employers said they are somewhat or very concerned they will trigger the tax based on their current plans and cost trajectory. More than four in 10 (43%) said avoiding the tax is the top priority for their health care strategies in 2015. As a result of the excise tax and other provisions of the health care reform law, CEOs and CFOs are more actively engaged in strategy discussions.

"In the current economic climate, affordability and sustainability remain dominant influences on employers' overall health care strategies," said Randall Abbott, senior consultant at Towers Watson. "Expense management and worker productivity are equally critical to business results. While employers are committed to providing health care benefits for their active employees for the foreseeable future, persistent concerns about cost escalation, the excise tax and workforce health have led to comprehensive strategies focused on both year-over-year results and long-term viability for health care benefits and workforce health improvement."

"The emphasis is on achieving or maintaining a high-performance health plan, continued Abbott. "And CFOs are now focused on a new gold standard: managing health cost increases to the Consumer Price Index. This requires acute attention to improving program performance."

## **COMBATting THE HIGH COST OF HEALTH CARE**

In response to short- and long-term cost concerns, a growing percentage (81%) of employers plan moderate to significant changes to their health care plans over the next three years, up from 72% a year ago. One tactic employers will use to curb spending in 2015 is specialty pharmacy management. Companies project that pharmacy-only cost trend will be 5.3% after plan changes (6% before changes). Employers will also embrace telemedicine for virtual physician office visits to improve access and efficiency of care delivery. Another key tactic is new payment approaches that hold providers accountable for the cost of an episode of care and outcomes.

Longer term, for 2016 and 2017, nearly half (48%) of employers are considering tying incentives to reaching a specified health outcome such as biometric targets, compared with just 10% that intend to adopt it in 2015; 37% are considering offering plans with a higher level of benefit based on the use of high-performance or narrow networks of medical providers, compared with just 7% in 2015. One-third (34%) of employers are considering telemedicine, compared with 15% in 2015, further accelerating technology as a way to improve engagement and medical care access, and manage costs.

Another cost-mitigation tactic being considered for 2016 and 2017 are changes in how employers subsidize health care for spouses and dependents. A third (33%) of employers are considering significantly reducing company subsidies for spouses and dependents; 10% have already implemented such reductions, and 9% intend to do so in 2015. In addition, 26% said they are considering spouse exclusions or surcharges if coverage is available elsewhere; 30% have that tactic in place now, and another 7% expect to add it in 2015.

Employers are also examining caps on health care coverage subsidies for active employees, using defined contribution approaches, with 30% of employers considering them for 2016 and 2017, 13% having them in place today and another 3% planning them for 2015.

## PRIVATE HEALTH EXCHANGE INTEREST IS GROWING

With regard to private health insurance exchanges for active workers, 28% of employers said they have extensively evaluated the viability of private exchanges. Nearly one in four (24%) said private exchanges could provide a viable alternative for their active full-time employees in 2016. The top three factors that would cause employers to consider a private exchange for full-time active employees are evidence they can deliver greater value than their current self-managed model (64%), adoption of private exchanges by other large companies in their industry (34%) and an inability to stay below the excise tax ceiling as 2018 approaches (26%).

Despite the challenge of managing the high cost of health benefits, nearly all employers (99.5%) said they have no plan to exit health benefits for active employees and direct them and their families to public exchanges, with or without a financial subsidy. Three out of four employers (77%) said they are not at all confident public exchanges will provide a viable alternative for their active full-time employees in 2015 or 2016.

"The most effective employers are continually evaluating new strategies for improving health plan performance," Abbott noted. "Examples include a steady migration to account-based health plans (ABHPs), action-based incentives, adoption of value-based payment methods with health plan partners and plan designs that drive efficiencies. Other options are technology-based solutions such as telemedicine, fitness devices or trackers, and social media to encourage employees to take a more active role in both their personal health status and how they use health care goods and services."

## OTHER NOTABLE FINDINGS

- Two-thirds of CEOs and CFOs are more directly involved in developing their company's health benefit strategies.
- The importance of data and metrics to evaluate health care benefit program performance is growing, with 60% of respondents planning to emphasize data as a gauge of performance.



- Three out of four employers (76%) are exploring the use of personalized digital technologies, including mobile health applications and fitness wearables, as well as social media to encourage greater activity among their employees.
- Full-replacement ABHPs (making ABHPs the only plan option) could be in place at 50% of companies by 2017: 17% offer only an ABHP today; 4% intend to do so for 2015, and another 28% are considering it for 2016 or 2017.

\*According to the Patient Protection and Affordable Care Act, in 2018, the federal government will impose a non-deductible excise tax on the value of employer-sponsored health programs that exceed an aggregate value of \$10,200 for individual coverage and \$27,500 for family coverage. The tax equals 40% of the value that exceeds these thresholds.

## ABOUT THE SURVEY

The 2014 Towers Watson Health Care Changes Ahead Survey offers insights into the focus and timing of U.S. employers' plans and perspectives related to their health benefits, and their efforts to better manage costs and employee engagement as well as their planned responses to the business risks associated with the 2018 excise tax. The survey was completed during July 2014 by 379 employee benefit professionals from midsize to large companies across a variety of industries and reflects respondents' 2014 – 2017 health care benefit decisions. The responding companies comprise a broad range of industries and business sizes, and collectively employ 8.7 million employees.

## ABOUT TOWERS WATSON

Towers Watson (NYSE, NASDAQ: TW) is a leading global professional services company that helps organizations improve performance through effective people, risk and financial management. The company offers consulting, technology and solutions in the areas of benefits, talent management, rewards, and risk and capital management. Towers Watson has more than 14,000 associates around the world and is located on the web at [towerswatson.com](http://www.towerswatson.com) <<http://www.towerswatson.com/en-US>>.

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**TOWERS WATSON****INSIDER****Health Care Cost Trends: Trouble Ahead?**

September 2012 | UNITED STATES | By Steve Nyce

Now that the Supreme Court's decisions on the Patient Protection and Affordable Care Act (PPACA) are behind us, employers are taking a much closer look at the law's components and planning their next steps, despite continuing uncertainty about some details as well as the law's longevity.

Employers' decisions about whether to pay or play — exit the health care system and pay the penalty versus provide an employer plan — or adopt a range of options in between will depend on many factors and their own unique circumstances. But as health benefits continue taking a bigger bite out of total rewards budgets, health care cost trends will be a common pressure point as employers consider their role in the new health care marketplace. The following analysis explores the recent slower growth in health costs and developments that might change the direction of that trend.

**KEY FINDINGS**

- There is cautious optimism about the slowing pace of health care cost trends over recent years.
- The risk of higher cost trends is growing partly due to the expansion of coverage under health care reform.
- Providers have consolidated to bolster their market clout and offset Medicare price cuts and Medicaid's inadequate fees through continued and greater cost shifting.
- The unchecked market power of some providers promises to become increasingly problematic for private payers, making it that much harder for employers to hold the line on costs and pushing many employers to rethink their ongoing commitment to their health care programs.

**HEALTH CARE SPENDING SLOWS**

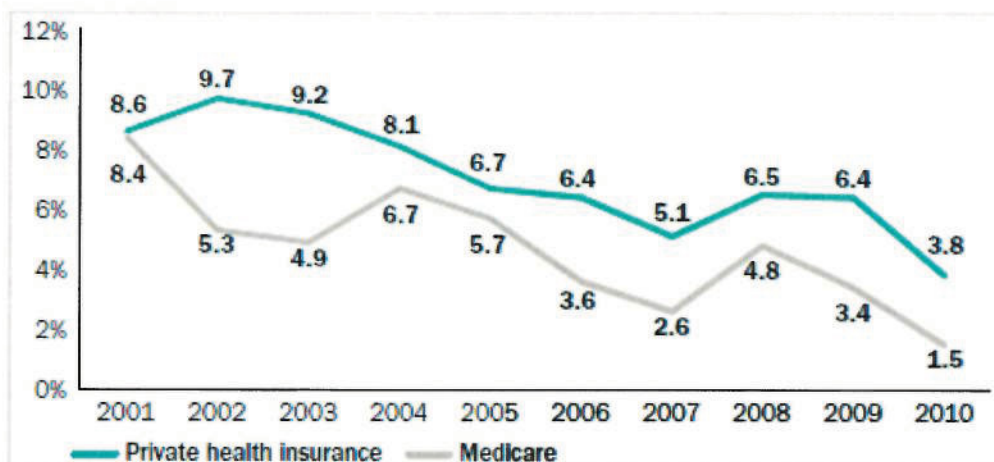
Historically, the growth of health care costs has been between 1% and 2.25% greater than potential gross domestic product (GDP)<sup>1</sup> — commonly referred to by economists and policymakers as “excess” health care spending. However, excess growth in health spending dropped below 1% for much of the 2005 – 2012 period, fueling cautious optimism about a slowdown.<sup>2</sup> In fact, some health experts have tossed caution aside, claiming that the private sector has made significant strides in innovating care delivery and that the trajectory of health expenditures is normalizing toward the regular rate of inflation.<sup>3</sup> That being the case, they don't believe health care reform was necessary to reduce costs.

As shown in *Figure 1*, the annual rate of increase in per enrollee health care spending has been declining for the past decade. Private health care cost trends stabilized between 5% and 7% during the 2005 – 2009 period and then dipped to roughly 4% in 2010. Medicare maintained a somewhat lower cost



trend over this same period, with average expenditures per enrollee rising by about 3% per year — roughly in line with the growth of GDP.<sup>4</sup>

**Figure 1. Average annual percentage increase in per enrollee Medicare spending and in private health insurance premiums, 2001 – 2010**



Source: Centers for Medicare & Medicaid Services, Office of the Actuary, National Health Statistics Group, Table 16.

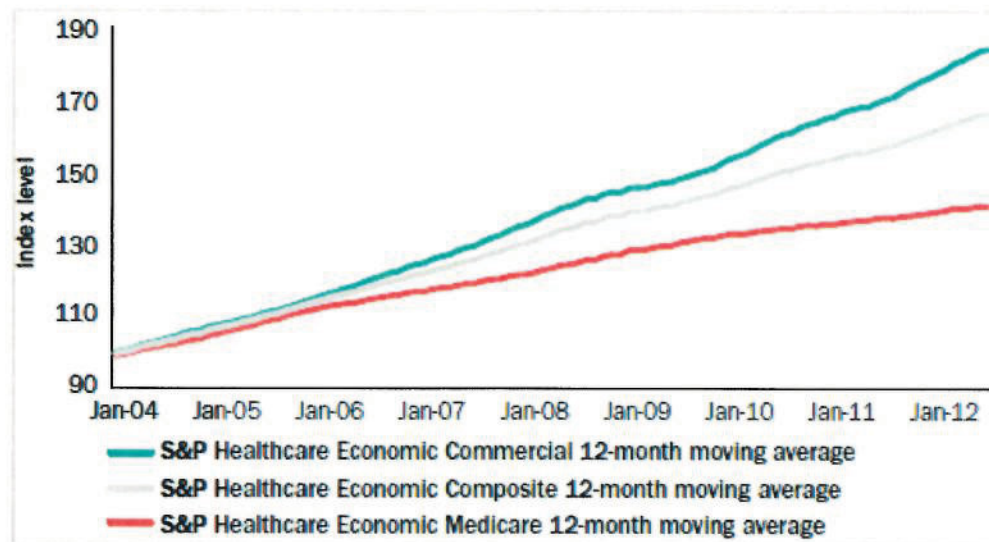
What accounts for the surprisingly slow growth of U.S. health care spending over the last few years? With a health system that has so many moving parts, it's impossible to pinpoint the source. But we know that health costs are driven by a combination of the volume of services being delivered and the prices charged for those services. Sorting out what has been happening with those, at least in the aggregate, suggests what is driving the trends in Figure 1.

Many suspect the recession and its aftermath have been slowing the pace of health care cost increases. Surveys of households indicate that Americans have scaled back all spending in recent years, including spending on health care services. They have been visiting the doctor less often, postponing elective medical procedures and reducing their use of prescription drugs. Physician office visits by non-elderly (under age 65) patients with private insurance have dropped off considerably, according to recent research from the Kaiser Family Foundation and IMS Institute for Healthcare Informatics.

In the years just before the economy faltered, about 160 million privately insured patients visited their doctors per quarter. By the second quarter of 2011, only 129 million did so — the fewest office visits over the last decade.<sup>5</sup> So utilization of health services has declined in recent years, at least by consumers with private insurance.

The Medicare trend shown in Figure 1 is lower than that of private insurance because of Medicare's more restrictive reimbursement policy. Figure 2 shows the Standard and Poor's Healthcare Economic Indices for commercial and Medicare payers, representing a composite of hospital and professional services.<sup>6</sup> Prices have clearly been rising much faster for services delivered under private insurance than for those delivered under Medicare.

**Figure 2. S&P Healthcare Economic Indices: 12-month moving averages, 2004 – 2012**



Source: S&P Indices.

Hospital charges were the biggest driver of the widening public-private price gap, with the commercial sector index increasing more than four times faster than the Medicare index over the last year — 8.85% versus 2.04%. Physician charges in the private sector outpaced those under Medicare by 2.5 times — 7.74% versus 3.11%. Congressional overrides to scheduled Medicare physician payment cuts at least partly explain the smaller Medicare/private sector growth differential for physician charges versus hospital charges. Also, Medicare's bundled payment approach for hospital charges could be more cost-effective than the private sector's predominant fee-for-service model.

There are more than just economic forces at work. Employers deserve considerable credit for adopting a wide range of cost-bending strategies, including account-based plans with higher out-of-pocket costs and value-based benefit designs, which provide different levels of coverage based on the value or cost of services. Employers have also been working harder to improve transparency in prices and hospital quality along with adopting communication approaches and new technologies that foster more cost-conscious consumer behaviors.<sup>7</sup>

More brand-name drugs going off patent combined with increased cost sharing have reduced prescription drug costs by encouraging consumers to choose cheaper generics; although the dramatic increase in the introduction, rate of use and costs of new specialty drugs could ultimately offset these savings. But the Congressional Budget Office — optimistic about future trends — trimmed \$100 billion over 10 years from its most recent revision to baseline projections for Medicare prescription drug spending.<sup>8</sup>

The big question is whether utilization will rebound as the economy does, driving costs higher. Or will consumers' cost-conscious behaviors and the trajectory of lower health care spending persist?

While many of the cost-reducing changes in consumer and provider behavior are likely to continue, the U.S. is facing increasing cost pressures from our aging population as well as millions of newly insured individuals under the PPACA. Moreover, the price inflation phenomenon for health services delivered under private insurance will have a potent expansionary effect on total costs if service delivery rates rebound to pre-recession levels. This analysis examines several of these factors in more detail.



## RETURN OF HIGHER COST TRENDS?

David Cutler, Harvard economist and an architect of the PPACA, contends that cost reduction is a centerpiece of the law. In a 2010 *Health Affairs* article, Cutler argued that the PPACA will modernize the delivery of services, thus building a more efficient, more effective and less expensive health care system. The reform's cost-reducing features include bundling medical services into larger payment groups, using value-based purchasing and improving care coordination. Cutler is counting on these changes to spark a productivity revolution, simultaneously reducing costs and improving the quality of care.<sup>9</sup> But Cutler recognizes that the success of these efforts to control long-run cost growth will require activism from the government and private sector.

Others are skeptical of Cutler's claims. Almost everyone agrees there is waste in our health care system, yet efforts to increase efficiency have yielded few improvements so far. The PPACA does little to eliminate unnecessary costs, and the payment system is not structured to reward innovative organizations such as Geisinger Health System<sup>10</sup> or Intermountain Healthcare, which are taking bold steps to deliver more efficient and higher-quality care. Similarly, naysayers fear that many of the promising pilot programs around care coordination and bundled payments are far too back-loaded — and many are scheduled to extend for over a decade.

But the greatest concern about the effect of health care reform on near-term cost trends relates to the expansion of coverage.<sup>11</sup> Major policy changes extending health insurance coverage to large segments of the population and changing financing incentives, payment mechanisms and the like will almost certainly affect health care pricing and increase use among the newly insured.

Medicare's introduction in the mid-1960s provides an illustrative example. The Advisory Council on Social Security Financing's initial projections underestimated the growth in hospital costs by roughly three to five percentage points per year over the implementation period. Two factors accounted for the divergence between the projections and the reality: The cost of services rose faster than anticipated and utilization rates exceeded expectations. The initial projections assumed that "hospital costs would rise by 2.7% more than wages over the first five years of the program's operations, then trend down to the wage growth rate over the next five years and for all subsequent years."<sup>12</sup>

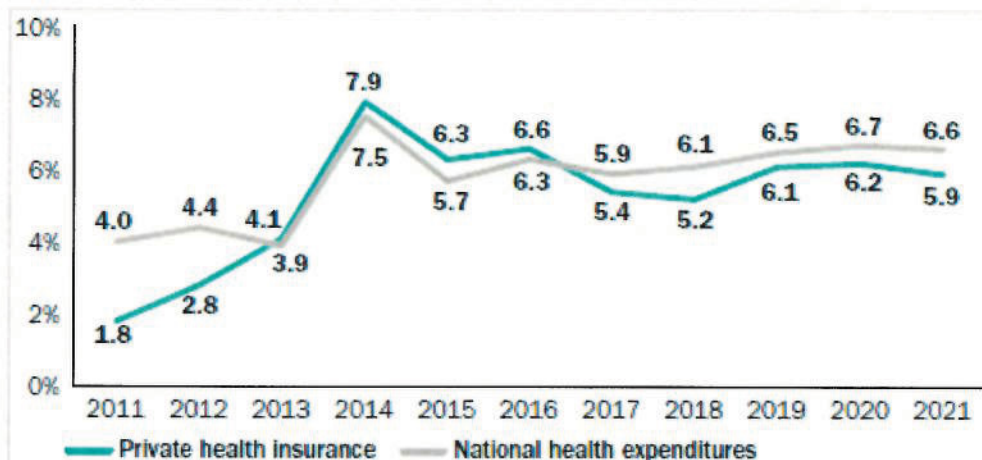
Over the first quarter century of Medicare's hospital insurance (HI) program, covered wages grew at an average compound rate of 6.2% per year, while the average price of a one-day hospital stay rose at a compound rate of 11.9%. Over the program's first 17 years, utilization levels consistently ran some 20% higher than even the most conservative Ways and Means Committee assumptions. Over the last 10 years of the projection period — when it was "conservatively" assumed that hospital costs would grow at the same rate as wages — HI costs were outpacing wages by 4.5 percentage points a year.

Estimates that had been repeatedly characterized as "conservative" turned out to be exceedingly optimistic. The underestimated price of services and utilization rates for Medicare's HI program were not simply additive in driving program costs — they compounded over time. If reality had conformed to expectations, HI program costs would have been less than half what they were in 1990. Health cost inflation stretched well beyond the financing of Medicare; it also affected the cost of health insurance benefits employers were providing to workers.<sup>13</sup>

The Centers for Medicare & Medicaid Services estimate that health care spending growth will nearly double from 2013 to 2014 — rising from 3.9% to 7.5% — as the demand for health care (particularly prescription drugs and physician care) surges (*Figure 3*). From 2015 through 2021, national health spending is expected to grow by an average 6.2% annually.<sup>14</sup> If there is a substantial surge in demand for services under health reform and price inflation returns to pre-recessionary levels, or even persists at

recent levels, the effects will be multiplicative. There is an important distinction, however, in that Medicare extended coverage to all those older than 65 — an expensive, high-risk population — while the PPACA is extending coverage to a lower-risk and less expensive population.

**Figure 3. Average annual growth from previous year in national health expenditures, 2011 – 2021**



Source: Centers for Medicare & Medicaid Services, Office of the Actuary, National Health Statistics Group.

Yet, the long-term outlook is for health care costs to grow roughly twice as fast as wages, with health insurance consuming an even greater portion of compensation packages and likely household budgets as well. Even Peter Orszag, former Director of the Office of Management and Budget (OMB), who helped put together the health reform package, and Ezekiel J. Emanuel, a special advisor to the White House and OMB during the law's development, suggest that in 2030, total health expenditures in the U.S. will be only 0.5% less as a share of GDP than under prior law.<sup>15</sup>

## COST DRIVERS BEYOND THE PPACA

Controlling health inflation has been likened to trying to constrain an expanding balloon as it is being filled with air. If you push on one side of the balloon, it simply expands faster on the other. Similarly, there is evidence that payers that focus on controlling prices lose the cost battle on the service delivery side. Those trying to manage utilization often fail to meet their goals because the cost of health services rises.

For some time, public health care payers — Medicare and Medicaid — have focused much of their cost-containment efforts on constraining health care prices, which are set administratively. Meanwhile, research over the last few decades has uncovered wide variations in medical treatments and health care spending across the Medicare population. Researchers at Dartmouth College have shown that two-thirds of the variations in spending arise from differences in the volume of health care services received by similar patients, much of which is not linked to better health outcomes, such as lower mortality or improved care.<sup>16</sup>

Private payers, in contrast, have concentrated on controlling the quantity of care delivered through capitation insurance designs, greater point-of-care cost sharing and more aggressive utilization reviews/audits. But new databases are beginning to enable more in-depth analysis into the most

powerful drivers of health care costs for the non-elderly population. One such initiative is being conducted by the independent, nonprofit Health Care Cost Institute (HCCI), which has one of the largest financial databases for the private marketplace, compiling health care claims from Aetna, Humana, Kaiser Permanente and UnitedHealthcare.

HCCI's inaugural research report highlights two important findings. First, it confirms that utilization dropped off significantly between 2007 and 2010. Second, between 2009 and 2010, per capita health care costs in the non-Medicare population were driven almost entirely by increases in unit prices.<sup>17</sup>

Pricing pressures have become a big headache for private payers. The ratio of private-payer rates to hospitals' service delivery costs increased from 116% in 2000 to 134% in 2009, according to a recent study by Paul Ginsburg.<sup>18</sup> Over the same period, the ratio of Medicare payment to service cost declined from roughly 100% to 90%.

How have providers been able to charge private payers more? Two intensifying trends are attracting growing scrutiny. First, market-leading health care providers, especially large hospital systems, are using their market power to demand high payment rates from private insurers. Second, cost shifting from Medicare and Medicaid to private payers is on the rise.

## GROWING PROVIDER LEVERAGE

The Center for Studying Health System Change conducts the Community Tracking Study, a longitudinal study of 12 nationally representative large metropolitan communities, which the center has visited roughly every two years since 1996. This study provides unique insights into the market dynamics of price negotiations within these communities. The most recent study interviewed 539 local health care leaders from prominent hospitals, physician groups and major health plans in these markets.

Plan and provider leaders agree that providers have been acquiring more leverage in their communities; as a result, insurers' ability to negotiate with major providers has declined. The so-called must-have hospital systems — due either to reputation or unique service offerings — have sufficient market heft to negotiate higher rates from insurers. And this trend extends beyond hospitals. Respondents broadly agree that small physician groups are largely “price takers” — those whose buying and selling transactions are assumed to have no effect on the market — while large physician groups have leverage comparable to top-tier hospitals, as their absence from a network would noticeably reduce its attractiveness.<sup>19</sup>

A critical factor driving the rising market leverage of providers is consumer demand for broad provider networks, which further constrains insurers' ability to negotiate aggressively with providers on price. Large hospital systems are using their power to expand their role in networks and demand entry into preferred tiers, even when inclusion is not justified by performance. Market consolidation also undermines attempts by plans or employers to counter the increasing leverage through market-based solutions, such as cost- and quality-based tiered networks. In negotiations, market-dominating health systems take the position that centers of excellence or tiered networks must include all the system's facilities, regardless of their outcomes or efficiency.

Importantly, the Community Tracking Study finds that health plans have largely accepted the reality of provider leverage. According to both plan and provider respondents, health plans generally accede to powerful providers' demands for payment increases, keeping payments low for hospitals with less negotiating clout. This dynamic creates a strong incentive for small hospitals and small physician groups to join forces, and the last decade has witnessed considerable growth in multihospital health care systems through mergers and acquisitions. A leading form of consolidation today has been through



noncompeting hospitals extending across large geographic areas, which in most cases avoids antitrust scrutiny.

Physicians have also been banding into larger groups to enhance their market clout. Moreover, many more hospitals have been hiring more physicians over the last few years, with the hospital-employed physicians gaining leverage over independent physicians by having hospitals negotiate on their behalf. This may also help hospitals with large physician contingents lock in favorable contract terms.

The PPACA might help curb the pricing power of providers, albeit indirectly. The law requires state insurance departments to annually review premium increases of 10% or more. Provider prices could come under greater scrutiny, particularly in markets with large jumps in payment rates. It is telling, however, that the market leaders responding to the Community Tracking Study do not expect the health care law to significantly reduce provider leverage in these market dynamics.

## HEALTH COST SHIFTING INTENSIFIES

A central funding component of the PPACA relies on reductions in future Medicare payments, including scheduled cuts in physician payments under Medicare Part B. These cuts have been on the books for roughly a decade, but Congress has "undone" them every year, fearing the cuts would prompt doctors to exit Medicare. As budget constraints loom, however, Congress will come under even greater pressure to pass the cuts established by the health care law or develop an alternative formula for sustainable growth rates, which could reduce provider rates.

Without question, slowing the growth of Medicare and Medicaid spending will be vital to reducing the U.S. long-term debt. But rate cutting within Medicare could simply shift the costs to the private market. Providers commonly cite inadequate Medicare and Medicaid payment rates as a reason for demanding higher rates from private insurers.<sup>20</sup> As providers have gained greater market leverage in many communities, the funding approaches in the health care reform law could make negotiations between providers and plans even more challenging.

Similarly, health care reform will increase the percentage of hospital patients enrolled in Medicaid, which pays less than employer-sponsored plans. If aggregate payment rates decline due to the Medicaid expansion, providers in dominant market positions will likely use their leverage to demand higher payment rates from employer-sponsored coverage. On the other hand, expanded coverage could mitigate some of the pressure on providers to shift the costs of uncompensated care onto private payers to recover the cost of treating those without health insurance.

But, as shown in Figure 2, cost shifting has been increasing for several years. The latest 12-month moving average of Standard and Poor's Healthcare Indices clearly shows the public and private cost curves bending in opposite directions. And the gap has been widening at a faster clip over the last few years. From June 2011 to May 2012, the S&P Healthcare Economic Medicare Index rose 2.6%, while the Commercial Cost Index rose 8.5%.

## CONCLUSION

Health care cost growth has seemed to slow over recent years, but this could be the calm before the storm. The unchecked market power of some providers promises to become increasingly problematic for private payers. If market solutions fail to steer employees to less costly providers and foster more efficiency, regulatory intervention becomes more likely. But the risk in the meantime is that the growth of



health care costs, which already consume a significant portion of employers' compensation budgets, will continue to outpace other compensation.

The potential for higher cost trends is alarming given the expanded health care coverage under the PPACA. These developments could make it that much harder for employers to hold the line on costs, further eroding the affordability of care for most Americans and prompting many employers to rethink their commitment to their health care programs. It is clearly too soon for optimism about future cost trends in the private sector.

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<sup>1</sup>Potential GDP is the highest level of real GDP that can be sustained over time.

<sup>2</sup>Roehrig, Charles, et al., "When the Cost Curve Bent — Pre-Recession Moderation in Health Care Spending," *The New England Journal of Medicine*, August 8, 2012.

<sup>3</sup>J. D. Kleinke, "[The Myth of Runaway Health Spending](http://online.wsj.com/article/SB10001424052970204792404577227050656680024.html)," *Wall Street Journal*, February 17, 2012.

<sup>4</sup>[Centers for Medicare & Medicaid Services, Office of the Actuary, National Health Statistics Group; U.S. Department of Commerce, Bureau of Economic Analysis; and U.S. Bureau of the Census](http://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/Downloads/tables.pdf) <<http://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/Downloads/tables.pdf>> .

<sup>5</sup>Kaiser Family Foundation, [The Economy and Medical Care, November 15, 2011](http://healthreform.kff.org/notes-on-health-insurance-and-reform/2011/november/the-economy-and-medical-care.aspx) <<http://healthreform.kff.org/notes-on-health-insurance-and-reform/2011/november/the-economy-and-medical-care.aspx>> .

<sup>6</sup>[S&P Healthcare Economic Indices, July 19, 2012](http://www.standardandpoors.com/indices/sp-healthcare-economic-indices/en/us/?indexId=sp-healthcare-economic-indices) <<http://www.standardandpoors.com/indices/sp-healthcare-economic-indices/en/us/?indexId=sp-healthcare-economic-indices>> .

<sup>7</sup>*The 17th Annual Towers Watson/National Business Group on Health Employer Survey on Purchasing Value in Health Care*, "[Performance in an Era of Uncertainty](http://www.towerswatson.com/research/6556)" <<http://www.towerswatson.com/research/6556>>, 2012.

<sup>8</sup>Medicare — March 2011 and 2012 Baseline estimates; 2012, available [here](http://www.cbo.gov/publication/43060) <<http://www.cbo.gov/publication/43060>> ; 2011 available [here](http://www.cbo.gov/publication/42240) <<http://www.cbo.gov/publication/42240>> .

<sup>9</sup>David Cutler, "How Health Care Reform Must Bend the Cost Curve," *Health Affairs*, June 2010, 29:61131-1135.

<sup>10</sup>Geisinger Health System employs several cost-reducing and quality-improving innovations, such as bundling payments for acute care procedures and better management of chronic disease.

<sup>11</sup>The Supreme Court's ruling on the Medicaid expansion might reduce the expansion somewhat. As of July 24, 2012, the Congressional Budget Office and the Joint Committee on Taxation estimate the insurance coverage provisions of the PPACA will have a net cost of \$1,168 billion over the 2012 – 2022 period, compared with \$1,252 billion projected in March 2012 — a net reduction of \$84 billion.

<sup>12</sup>Robert J. Myers, Actuary to the Committee on Ways and Means, "Actuarial cost estimates and summary of provisions of the Old-Age, Survivors, and Disability Insurance Systems as modified by the Social Security Amendments of 1965 and actuarial cost estimates and summary of provisions of the Hospital Insurance and Supplementary Medical Insurance Systems as established by such act," Committee on Ways and Means, House of Representatives, 89th Congress, First Session, July 1965, p. 28.

<sup>13</sup>For a more detailed discussion, see Steven A. Nyce and Sylvester J. Schieber, "[Treating Our Ills and Killing Our Prospects](http://www.towerswatson.com/assets/pdf/5216/Towers-Watson-Treating-Ills-Full-Report.pdf)" <<http://www.towerswatson.com/assets/pdf/5216/Towers-Watson-Treating-Ills-Full-Report.pdf>>," Towers Watson White Paper, August 2011.

<sup>14</sup>Sean P. Keehan et al., "National Health Expenditure Projections: Modest Annual Growth Until Coverage Expands and Economic Growth Accelerates," *Health Affairs* 31, No. 7 (July 2012).

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<sup>16</sup>Elliott Fisher, David Goodman, Jonathan Skinner and Kristen Bronner, "Health Care Spending, Quality, and Outcomes; More Isn't Always Better," *A Dartmouth Atlas Project Topic Brief* (February 2009).

<sup>17</sup>[Health Care Cost and Utilization Report](http://www.healthcostinstitute.org/reports) <<http://www.healthcostinstitute.org/reports>> , Health Care Cost Institute, May 2012.

<sup>18</sup>Paul B. Ginsburg, "Reforming Provider Payment — The Price Side of the Equation," *The New England Journal of Medicine*, 365; 14, October 6, 2011.

<sup>19</sup>Robert A. Berenson et al., "The Growing Power of Some Providers to Win Steep Payment Increases From Insurers Suggests Policy Remedies May Be Needed," *Health Affairs*, May 2012.

<sup>20</sup>See [endnote 18](#).

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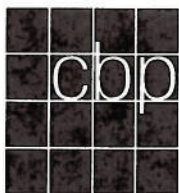
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**APPENDIX –C:**

California Budget Project Budget Brief, January 7, 2014 “Poverty in the Golden State: Where  
California Stands 50 Years Since the War on Poverty Began.”





CALIFORNIA BUDGET PROJECT

# budget brief

JANUARY 7, 2014

## POVERTY IN THE GOLDEN STATE: WHERE CALIFORNIA STANDS 50 YEARS SINCE THE WAR ON POVERTY BEGAN

**J**anuary 8, 2014 marks the 50th anniversary of President Lyndon B. Johnson's declaration of an unconditional War on Poverty, made during his 1964 State of the Union address. Although poverty remains a reality for millions of Californians, the last half-century has shown the key role that public policies can play in reducing poverty and fostering economic security. With state policymakers set to begin crafting a new state budget, this *Budget Brief* looks at poverty in the Golden State and discusses some ways that policymakers can help reduce economic hardship and expand pathways to opportunity and advancement.

### Public Policies Can Reduce Poverty and Address Its Impacts

Over the last 50 years, efforts to strengthen the "social safety net" – the public services and benefits that help provide a basic level of subsistence – have helped combat poverty and have alleviated economic hardship for millions of individuals and families. By one estimate, safety-net policies helped reduce the national poverty rate from 26 percent in 1967 to 16 percent in 2012 – a decline of more than one-third.<sup>1</sup>

In California, the social safety net comprises individual programs that fight poverty on a number of fronts. Some programs provide in-kind assistance that helps families obtain food or afford housing. For example, the federal Supplemental Nutrition Assistance Program (SNAP) – known as CalFresh in California – provides food assistance to low-income families. The Public Policy Institute of California estimates that CalFresh helped 800,000 individuals, including 380,000 children, escape poverty in 2011.<sup>2</sup>

Other programs provide modest cash assistance to low-income Californians. One such program, California Work Opportunity

and Responsibility to Kids (CalWORKs), helped lift approximately 470,000 Californians – about half of them children – out of poverty in 2011. Other safety-net programs include tax credits for working families and programs that increase access to affordable health care.<sup>3</sup>

The social safety net plays a critical role in keeping Californians out of poverty. According to the US Census Bureau, safety-net programs on average kept nearly 4 million Californians, including 1 million children, out of poverty between 2009 and 2011.<sup>4</sup>

### Many Californians Still Struggle in the Aftermath of the Great Recession

Although the social safety net has proven to be a vital tool in the fight against poverty, many Californians nonetheless are struggling in the aftermath of the Great Recession, the worst economic downturn in generations. The labor market is still weak despite more than three years of sustained economic growth, with California's unemployment rate (8.7 percent in October 2013) remaining higher than at any point during or following the 2001 recession.<sup>5</sup> The official federal poverty measure shows that:

- **Poverty in California is nearly one-third higher now than before the Great Recession.** Nearly 16 percent of Californians – more than 6 million people – had incomes below the federal poverty line in 2012, compared to 12.2 percent in 2006, the last year before the recession began.<sup>6</sup>
- **Poverty is more common among children than for the population as a whole.** In 2012, 22.5 percent of the state's children – 2.1 million – were living in poverty, according to the official measure (Figure 1). This child poverty rate is nearly seven percentage points higher than California's overall poverty rate of 15.9 percent.

Unfortunately, the official poverty measure *understates* the extent of economic hardship in California. Newer, alternative measures of poverty more accurately estimate economic well-being, because they not only factor in cash income and other resources provided by public programs, but also account for the costs of housing, medical expenses, and other necessities.

California's high cost of living means that more people struggle to make ends meet than the official measure estimates, even after accounting for the poverty-reducing effect of public programs. One alternative poverty measure – the US Census Bureau's Supplemental Poverty Measure – shows that, on average, 23.8

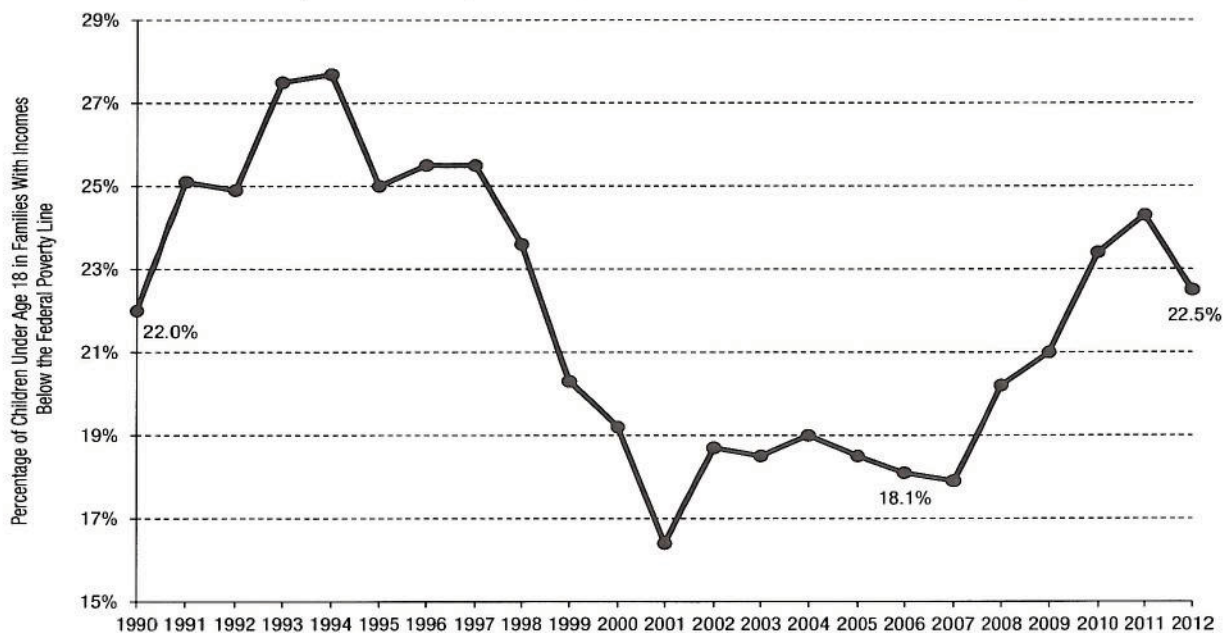
percent of Californians lived in poverty between 2010 and 2012, well above the official poverty rate for these three years – 16.5 percent.<sup>7</sup>

## Continuing the War on Poverty in California

Fifty years since the War on Poverty began, there is clearly much more to be done. As President Johnson said in his 1964 address, while poverty is a national problem, "this attack, to be effective, must also be organized at the state and the local level and it must be supported and directed by state and local efforts." California's leaders can reduce poverty by making budget and policy choices that extend the reach of public programs and provide the necessary investments in people and the state's future. State lawmakers can:

- **Ensure that public programs and services that help reduce poverty and alleviate economic hardship reach those who need them most.** For example, only 55 percent of Californians who were eligible for SNAP/CalFresh received this food assistance in 2010 – the lowest SNAP participation rate in the nation.<sup>8</sup> Boosting participation in CalFresh – and in other critical programs for low-income individuals in California – would help families make ends meet and reduce economic hardship.

**Figure 1: Nearly One Out of Four California Children Were Living in Poverty in 2012**  
Child Poverty Rate Remains Nearly One-Fourth Higher Than in 2006, the Year Before the Great Recession Began



Source: US Census Bureau



- **Reinvest in programs that assist low-income families with children.** Many important services for low-income Californians have been cut deeply in recent years. For example, state policymakers repeatedly cut CalWORKs cash assistance and significantly reduced the amount of time that parents may participate in the full array of job training services offered through CalWORKs. At the same time, state policymakers have cut funding for child care and preschool programs, which help lower-income parents find and keep jobs while also promoting children's future academic success. State spending cuts have reduced the number of child care and state preschool slots by over 100,000 since 2007-08 – a decline of more than one-quarter.<sup>9</sup>
- **Take a sustained, multifaceted approach to strengthening California's workforce and its economy.** Central to reducing poverty is expanding economic opportunity for low-income families, and California can do this in part by supporting the building blocks of economic growth. This means reinvesting in education across the spectrum, including early education, K-12 schools, colleges and universities, and adult education. This also means making strategic investments in infrastructure, so that the state's transportation, water, energy, and communication networks meet the needs of California's economy and its communities.

Luke Reidenbach prepared this Budget Brief. The CBP was established in 1995 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, subscriptions, and individual contributions.

## ENDNOTES

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- <sup>4</sup> Center on Budget and Policy Priorities analysis of US Census Bureau data. See Arloc Sherman, Danilo Trisi, and Sharon Parrott, *Various Supports for Low-Income Families Reduce Poverty and Have Long-Term Positive Effects on Families and Children* (Center on Budget and Policy Priorities: July 2013).
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- <sup>6</sup> See California Budget Project, *New Census Data Show That More Than 6 Million Californians – Over One-Third of Them Children – Lived in Poverty in 2012* (September 2013) for additional analysis of the most recent US Census Bureau poverty data.
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- <sup>8</sup> US Department of Agriculture, *Reaching Those in Need: State Supplemental Nutrition Assistance Program Participation Rates in 2010* (December 2012).
- <sup>9</sup> See California Budget Project, *Starting Strong: Why Investing in Child Care and Development Programs Is Critical for Families and California's Economic Future* (November 2013) for additional analysis.